

UNITED STATES DISTRICT COURT  
EASTERN DISTRICT OF MICHIGAN  
NORTHERN DIVISION

AVKO EDUCATIONAL RESEARCH  
FOUNDATION, a Michigan  
Corporation, and DONALD J.  
McCABE, Author,

Plaintiffs,

v.

File No. 11-13381

THOMAS A. MORROW, an individual,  
WAVE 3 LEARNING, INC., HOME  
SCHOOL HOLDINGS, INC., and  
HOME SCHOOL, INC.,

Defendants.

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MOTION FOR TEMPORARY RESTRAINING ORDER

BEFORE THE HONORABLE THOMAS L. LUDINGTON

United States District Judge

United States Post Office Building

1000 Washington Avenue

Bay City, Michigan 48708

Monday, January 23, 2012

APPEARANCES:

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IDENTIFIED

None.

1 Bay City, Michigan

2 Monday, January 23, 2012

3 9:13 a.m.

4 (Court, counsel and parties present)

5 THE LAW CLERK: Calling the case of AVKO  
6 Educational Research Foundation, et al, versus Morrow,  
7 et al, Case No. 11-13381.

8 MS. WOODROW: Susan Payne Woodrow on behalf of  
9 AVKO and Don McCabe. I'm prepared to proceed this  
10 morning.

11 THE COURT: Good morning.

12 MR. DI GIACOMO: John Di Giacomo on behalf of  
13 Wave 3 Learning and Thomas Morrow, your Honor.

14 THE COURT: Good morning.

15 MR. DI GIACOMO: Good morning.

16 THE COURT: Miss Woodrow --

17 MS. WOODROW: Yes, your Honor.

18 THE COURT: -- could you introduce me to the  
19 folks that are at counsel table with you, please.

20 MS. WOODROW: I would be delighted to. This  
21 is Mr. Donald McCabe and he is the author of the works  
22 over there (indicating) and this is Robert McCabe and  
23 he is the director of AVKO Educational Foundation,  
24 Incorporated.

25 THE COURT: All right. And there is also a

1 gentleman by the name of Brian. Brian McCabe?

2 MS. WOODROW: Brian McCabe is not here. He is  
3 Robert McCabe's son and is not participating today.

4 THE COURT: Okay.

5 MS. WOODROW: I did not feel his testimony would  
6 be necessary in this evidentiary hearing.

7 THE COURT: And Mr. McCabe's first name is  
8 Donald, correct?

9 MS. WOODROW: Donald, yes. It is Donald J.

10 THE COURT: Okay.

11 MS. WOODROW: Yes, your Honor. I have two other  
12 witnesses that will be -- other witnesses that will be  
13 testifying. Do you need their names at this time?

14 THE COURT: I do not.

15 MS. WOODROW: Thank you.

16 THE COURT: We will talk about them here in a  
17 few minutes. Could you introduce me --

18 MR. DI GIACOMO: Yes, your Honor. This is  
19 Thomas Morrow. He is the president of Wave 3 Learning  
20 and also the named defendant as well.

21 THE COURT: Thank you.

22 MR. DI GIACOMO: Thank you.

23 THE COURT: I have about three hours. What  
24 would you like to accomplish this morning?

25 MS. WOODROW: I believe we have an evidentiary

1 hearing --

2 THE COURT: We do.

3 MS. WOODROW: -- for the preliminary injunction  
4 and I have several witnesses. I felt when we talked  
5 about it before, we -- at the status conference, that we  
6 would have probably nine hours worth of testimony and so  
7 I could begin with my first witness and we can move  
8 forward from there, your Honor.

9 THE COURT: Well, we can split -- split up the  
10 hearing. I mean, I have to balance your case --

11 MS. WOODROW: I know.

12 THE COURT: -- timewise with about 500 others.

13 MS. WOODROW: Yes, I understand.

14 THE COURT: And I've got a multi-defendant case  
15 that needs attention at one.

16 Now, I've spent about an hour kind of walking my  
17 way through some of the information in the materials. If  
18 you don't mind, what I would like to do in a somewhat  
19 informal opening statement, so I can get an understanding  
20 for where the parties agree, where the parties disagree  
21 on certain factual information, it would be helpful to  
22 me.

23 I'm familiar, generally, with the materials that  
24 Mr. McCabe has developed, the learning materials, over  
25 my -- my brief review of that information.

1 Can you tell me a little bit more about Mr.  
2 McCabe, his historical background and his development of  
3 the works?

4 MS. WOODROW: Yes, your Honor.

5 THE COURT: If you would like to use the  
6 podium --

7 MS. WOODROW: Certainly.

8 THE COURT: -- it's probably helpful.

9 MS. WOODROW: Fine. Thank you, your Honor.

10 Yes, Mr. McCabe was -- is an educator and he was  
11 trained, I believe, in English and in the reading skills  
12 and he was a teacher of English in high school, then was  
13 transferred to another -- to junior high, I believe, and  
14 for more disadvantaged -- more disadvantaged students.

15 And in that quest, he discovered that many of  
16 the students were not able to read. He thought about it,  
17 discussed it and learned that how he had learned to read  
18 as a dyslexic was the way that he could then teach the  
19 dyslexics because many of the youngsters that could not  
20 read were dyslexic.

21 He developed a system. He worked on it several  
22 summers and created the first book, the first couple of  
23 books, Sequential Spelling, and from there, he has  
24 developed a whole series of books. He copyrighted them  
25 in the late '70s.

1 THE COURT: They were not registered.

2 MS. WOODROW: Pardon?

3 THE COURT: Copyrights were not registered.

4 MS. WOODROW: They are registered.

5 THE COURT: They are.

6 MS. WOODROW: Yes. We have a stack of ancient  
7 documents here. We have the original registrations with  
8 us, your Honor.

9 THE COURT: Would the copyright dates predate  
10 1978?

11 MS. WOODROW: Yes. They -- they come under the  
12 '95 years. I can look in my book but they are covered.  
13 They are still valid. They did not need to be renewed.  
14 There was a window during which they needed to be renewed  
15 and these do not fit within that window.

16 THE COURT: I see your opposing counsel  
17 squirming in his chair.

18 MS. WOODROW: Pardon?

19 THE COURT: I see your opposing counsel  
20 squirming in his chair.

21 MS. WOODROW: He probably may disagree with me.

22 THE COURT: Indeed. So what was he doing during  
23 the period of time? Who was he working for when most of  
24 these -- the work was completed on --

25 MS. WOODROW: I believe the Flint school system.



1 THE COURT: As soon as he had registered them or  
2 at least sometime thereafter, AVKO was created.

3 MS. WOODROW: Correct. He then transferred  
4 the -- he transferred and assigned the -- the copyrights  
5 to AVKO and I don't have the exact date of that but I can  
6 get that for you. That's in my documents. He assigned  
7 them to AVKO and then began to publish them and print  
8 them through AVKO. And distribute them and sell them and  
9 market them.

10 THE COURT: What -- what is AVKO?

11 MS. WOODROW: AVKO is a non-profit educational  
12 foundation and the purpose is not only to further reading  
13 but other educational opportunities and -- opportunities  
14 and techniques.

15 He is hoping to have a summer camp to teach  
16 teachers how to teach reading and to also help the  
17 children how to learn how to read. He is also -- they  
18 wish -- there are other opportunities and other projects  
19 that AVKO wishes to go into but, of course, they have  
20 not -- they have been stopped by it because of the lack  
21 of funding. They expected to have funding through the  
22 sale of the publishing rights and they have not been  
23 able -- since the sale has not occurred, they haven't  
24 been paid. They can't go forward in any of these  
25 educational ventures. I would have to ask Mr. McCabe in

1 greater detail about those.

2 THE COURT: What -- what is AVKO under state  
3 law? Is it a --

4 MS. WOODROW: It's a 501c.

5 THE COURT: That's its federal designation.

6 MS. WOODROW: And you know, I don't know, but it  
7 is -- I can ask Mr. McCabe. He would have that  
8 information. But it is a tax-free foundation.

9 THE COURT: Is it a membership or a directorship  
10 non-profit organization?

11 MS. WOODROW: It has members and it also had a  
12 board of directors.

13 THE COURT: Okay. It's nevertheless  
14 incorporated as a non-profit under state law.

15 MS. WOODROW: That's what my understanding is.

16 THE COURT: Under the Internal Revenue Service  
17 code, is it a private foundation or is it simply exempted  
18 from income tax under 501c3?

19 MS. WOODROW: It's a public foundation.

20 THE COURT: Okay. You indicated that the  
21 works would have been completed sometime, what, in 2008,  
22 2009?

23 MS. WOODROW: Works was completed?

24 THE COURT: Mm-hmm, as a -- as a commercial body  
25 of materials that could be published.

1 MS. WOODROW: I think it was published -- they  
2 were being published early, many, many years ago.

3 THE COURT: How long ago?

4 MS. WOODROW: I can't speak to that. Mr.  
5 McCabe, when was Sequential Spelling first published,  
6 19 --

7 MR. McCABE: 1975, I believe.

8 THE COURT: All right.

9 MS. WOODROW: And continuously thereafter?

10 THE COURT: And what --

11 MR. McCABE: There is -- there are all kinds of  
12 books that were published all along the way. I didn't  
13 get to be able to do these (indicating) in one summer's  
14 time.

15 These contain all the words of the English  
16 language except those which you find on bathroom walls.  
17 I left those out and the very esoteric scientific and  
18 medical terminology. Other than that, it contains all  
19 the words of the English language arranged by patterns  
20 and those that have no patterns, that I call the outlaw  
21 or insane words, they are -- they are all put together  
22 according to basic usage. In other words, I would have  
23 words like "was" long before I would have L-O-U-G-H,  
24 lough, long before I would have Q-U-A-Y-D.

25 THE COURT: Mm-hmm. What was the commercial

1 viability of these works, if you will, between, let's  
2 say, 1980 and the early 2000s? Were they assigned to  
3 AVKO at a particular period of time?

4 MS. WOODROW: I believe they were assigned to  
5 AVKO and developed and some of the -- some parts were  
6 developed by AVKO, additional parts, and they were always  
7 commercially available by AVKO.

8 THE COURT: And I understand where the human  
9 capital came from. It's standing over here. Where did  
10 the operating capital come from that enabled the  
11 gentleman --

12 MS. WOODROW: The funding?

13 THE COURT: -- to have AVKO --

14 MS. WOODROW: The funding, your Honor?

15 THE COURT: -- actually publish those materials,  
16 yes.

17 MR. McCABE: It came from my cashing in of my  
18 pension. So I have no pension. It came from my wife's  
19 very generous donations to the foundation and, of course,  
20 from the sales and occasional grants, for example, the  
21 Newman -- Paul Newman Foundation. That was a grant and I  
22 forget a couple other foundations have given us small  
23 grants. But that's where most of the funding has come  
24 from, is from private donations and from sales of the  
25 materials to try and keep us going. I have not collected

1 a single cent in salary.

2 THE COURT: Tell me a little bit about the sales  
3 experience that you had with the materials before it was  
4 assigned to AVKO and after it was assigned.

5 MR. McCABE: I'm sorry. My hearing is not very  
6 good.

7 MS. WOODROW: Did you -- I don't believe that he  
8 sold -- did you sell any materials before they were  
9 assigned to AVKO?

10 MR. McCABE: No. No. Wait a minute. No, no, I  
11 didn't.

12 THE COURT: And how about afterwards?

13 MR. McCABE: After I assigned the copyrights to  
14 AVKO, then we sold and could not have any direct profits  
15 coming to me directly from the foundation. I cannot -- I  
16 cannot profit as an individual and I have not. That, of  
17 course, has made it very difficult. You cannot really  
18 raise money by having stock because you can't do that.  
19 And to borrow money from banks, that was pretty much out  
20 of the question.

21 THE COURT: Well, I'm a bit at a loss of  
22 understanding why you transferred the copyrights to a  
23 charitable organization as opposed to a for profit  
24 entity.

25 MR. McCABE: Oh, as opposed to a for profit?

1 THE COURT: Yes, sir.

2 MR. McCABE: Well, at the time, there wasn't any  
3 for profit organization that I could sell them to and I  
4 can explain why, because everything that I have developed  
5 for the foundation cannot be found anywhere, anywhere, in  
6 the educational world.

7 These are things that I developed because I am a  
8 dyslexic. Those who develop reading materials are not  
9 dyslexic and as you perhaps know the adage, those who can  
10 do and those who can't teach. Well, those who can't  
11 teach cannot handle a classroom. They get their Ph.D.s  
12 and they teach the teachers how to teach and they are the  
13 ones that the publishers go to to create their works and  
14 how to teach kids how to read.

15 THE COURT: Now --

16 MS. WOODROW: But Mr. McCabe --

17 THE COURT: -- how did you make the decision to  
18 create a non-profit entity that obtained its charitable  
19 exemption from taxation to be the recipient of that  
20 intellectual property rather than simply capitalizing on  
21 it in a profit organization?

22 MR. McCABE: Because according to the law, as  
23 it was read to me or explained to me by my attorney,  
24 my copyright attorney, that I could not profit from a  
25 sale of the copy -- from the books if AVKO published

1    them.

2                   MS. WOODROW: I think, Mr. McCabe, the question  
3    is, why didn't you form a real company called Sequential  
4    Spelling, Inc., that would sell them for money for profit  
5    so that you could make a profit?

6                   MR. McCABE: Because I was not interested in  
7    making a whole lot of money. I was interested in getting  
8    the word out. And at the time, I felt this was the  
9    proper way to go. It may -- may have been the wrong way  
10   to go.

11                  THE COURT: Well, you had made the point to me a  
12   few minutes ago that your wife had -- was -- had made  
13   some financial contributions and that you had exhausted  
14   portions of your pension in order to develop this -- this  
15   intellectual property.

16                  MR. McCABE: Yes.

17                  THE COURT: Why would you put it in a charitable  
18   organization that you could not personally benefit from  
19   given the fact that you had all this invested material?  
20   Had you deducted the charitable contributions that you  
21   had made and utilized that as an offset against your  
22   reported income to the Internal Revenue Service?

23                  I'm trying to understand what your strategic  
24   motives were given the fact that you and your wife had  
25   invested a fair amount of effort in this and yet you

1 created a public charity from which it would be difficult  
2 to recover any of that investment.

3 True?

4 MR. McCABE: My intentions were never to make a  
5 whole lot of money, never. And I felt that the best way  
6 at the time was to be a non-profit organization that  
7 would be -- would carry, let's say, a little more respect  
8 trying to get the word out to the educational  
9 establishment than a private money-making corporation in  
10 which their whole object is the bottom line.

11 My object was never the bottom line but that is  
12 what it is in a -- a corporation such as Wave 3. And I  
13 have no qualms about them making money. I hope they  
14 would make a whole lot of money but they could -- they  
15 were in a position, I felt, to make a lot of money -- not  
16 actually Wave 3. It was Home School Holdings at the  
17 time.

18 THE COURT: What kind of reportable revenue are  
19 we talking about for the third parties are willing to pay  
20 for the published works between 1980 and 2006? Are we  
21 talking about an income stream in the range of thirty  
22 thousand, sixty thousand, two hundred sixty thousand, two  
23 million six hundred thousand?

24 MR. McCABE: I'm not sure of the amounts. It's  
25 certainly less than three hundred thousand from the -- of



1 any of the years between there.

2 THE COURT: Less than three.

3 MR. McCABE: My guess would be somewhere in the  
4 neighborhood as we're going up between those years, it  
5 would average probably around a hundred twenty-five, a  
6 hundred fifty thousand.

7 It didn't really go up until we were picked up  
8 by Sonlight Curriculum, as far as just the Sequential  
9 Spelling and they picked it up because their -- they had  
10 used it with their own children and because it worked so  
11 well with them, they were willing to contact me and ask  
12 me if I would change a little bit of the format from the  
13 one page across to a two-column introduction and make a  
14 few minor changes. They arranged for a publish -- for a  
15 printer. They arranged for the printer to give AVKO  
16 credit and arranged --

17 THE COURT: And my memory and in briefly  
18 reviewing this within the short conference that I've had  
19 with counsel was that the numbers ranged between about  
20 sixty and two hundred thousand, that that range was --  
21 captures the revenue stream fairly accurately.

22 MS. WOODROW: I think the maximum revenue was  
23 around \$291,000.

24 THE COURT: Okay. I recall that. And a  
25 number of years that it was around eighty or less, more

1 or less.

2 MS. WOODROW: That I don't know, your Honor.

3 THE COURT: Okay. That now takes us then, to  
4 some degree, to 2010. Can you tell me what happens in  
5 2010 that's relevant to the case?

6 MS. WOODROW: That is relevant to the case? In  
7 2010, a contract is signed -- well, it actually begins in  
8 June of 2009 when Mr. Morrow and Mr. McCabe meet at a  
9 convention or at some sort of a show for products and  
10 part of the purpose of Mr. Morrow going to the shows was  
11 to find small companies that he could acquire for Home  
12 School Holdings.

13 And Home School Holdings was at that time  
14 coordinating with Narayan, to purchase Narayan as a  
15 company because it was already public-oriented somehow,  
16 so that they could create a public offering of Home  
17 School Holdings in order to gain income. And their first  
18 SEC S-1 was for fourteen million dollars. That was in  
19 July of 2009.

20 Mr. Morrow opened up negotiations with Mr.  
21 McCabe and they had contracts, went back and forth and  
22 they talked about -- the contracts went back and forth,  
23 with changes and changes until finally, they signed a  
24 contract on June 4th, 2010.

25 Prior to that signing, Mr. Morrow indicated that

1 he would be signing as an individual but yet, he signed  
2 it under the title of CEO of Home School Holdings, Inc.  
3 There is some dispute as to whether or not he had actual  
4 authority at the moment of signing. But he does not  
5 discount or abrogate the contract. He actually lived by  
6 the contract.

7 THE COURT: Can we stop there for a moment.

8 MS. WOODROW: Yes, your Honor.

9 THE COURT: The contract is signed on June 4 of  
10 2010. You indicated to me that Mr. McCabe met Mr. Morrow  
11 in approximately June of 2009. Where did they physically  
12 meet? What was the first instance in which --

13 MS. WOODROW: In 2009? At a show, some sort of  
14 show for schools. Where did you meet, Mr. McCabe?

15 MR. McCABE: At the Florida Family Education  
16 Association.

17 MS. WOODROW: In Orlando?

18 MR. McCABE: A conference in Orlando, Florida.  
19 I met him as I was -- I was looking for a distributor or  
20 this is why I went to these. Besides getting the word  
21 out, I was looking for distributors. That's how I found  
22 Rainbow and Timberdoodle and a few of the others.

23 MS. WOODROW: You had about 20 distributors,  
24 didn't you, 18 to 20, that you had?

25 MR. McCABE: I'm not sure how many.

1 MS. WOODROW: Okay.

2 MR. McCABE: But that's one of the reasons I was  
3 there, to find a distributor and --

4 THE COURT: Kind of like the way things are  
5 set up here in the courtroom.

6 MR. McCABE: And he said he was a --

7 THE COURT: Bay City Convention Center.

8 MR. McCABE: Right after the convention, he came  
9 up to see the AVKO Foundation and to begin making a  
10 proposal to purchase the publishing rights.

11 THE COURT: Now, if I understand accurately, the  
12 entrepreneurial objective up to that point was to find a  
13 distributor with AVKO maintaining the copyrights for the  
14 materials, producing a stream of income, that it was not  
15 anticipated that Mr. McCabe would profit from.

16 Do I have this correctly?

17 MS. WOODROW: Correct. Mr. McCabe had prior  
18 thereto been handling all the publishing, handling the  
19 printing, handling the nuts and bolts and, you know, the  
20 carrying and lugging of the boxes and seeing that they  
21 got shipped and he wanted to -- what he calls the  
22 publishing --

23 THE COURT: But recognize, I think, that we need  
24 to draw some distinctions here based on some decisions  
25 that he had made. He had developed an exceptional

1 product of particular value for certain students but he  
2 elected to place it into a non-profit organization,  
3 notwithstanding the fact that both he and his wife had  
4 made very significant contributions to the development of  
5 this product.

6 MS. WOODROW: Correct.

7 THE COURT: It was at that point not just his  
8 baby. It was the foundation's baby.

9 MS. WOODROW: Correct.

10 THE COURT: It had grown up and he had  
11 transferred it to another organization. Am I correct in  
12 understanding that at least at that juncture, he had no  
13 intention of profiting from this enterprise and that's  
14 why he selected a non-profit organization. It has limits  
15 that are placed on the private inurement that go with  
16 any non-charitable organization.

17 Am I correct at this stage?

18 MS. WOODROW: Mr. McCabe?

19 MR. McCABE: I wanted AVKO to profit from the  
20 publishing by Home School Holdings. I wanted AVKO to end  
21 up with enough money to be able to help solve the  
22 horrible literacy problem that exists in our country and  
23 you can -- if you ever are curious, you can go to our  
24 website and watch a small video which I take a dyslexic  
25 who came to the foundation, and by the way, I have never

1 once charged one penny. The AVKO Foundation does not  
2 charge for its free daily tutoring or for the training of  
3 parents on how to -- to tutor their own children.

4 This is a passion of mine and I don't think I  
5 need to go into all of it. If you want to find out  
6 everything about how this came about, how the foundation  
7 came about, it's in my book, "To Teach a Dyslexic."

8 Just like the idea it takes a thief to catch a  
9 thief, it takes a dyslexic to know how to teach a  
10 dyslexic. And what I did in that video is take a kid  
11 from Mississippi and I -- and I had his first lesson, I  
12 had the video camera, I hired a small inner city -- what  
13 was the name of the -- Inner City Productions, that's the  
14 title, they were there to capture the very first lesson.  
15 And at the start, I handed up a card that had a word  
16 "malicious" on it and I asked him if he could read it.  
17 He couldn't.

18 THE COURT: And I appreciate that.

19 MS. WOODROW: Mr. -- Mr. McCabe.

20 THE COURT: Ma'am.

21 MS. WOODROW: Oh.

22 THE COURT: I have a great affinity for your  
23 product. As I've mentioned even to your attorney, both  
24 the attorneys, I had a father that was dyslexic who  
25 struggled with that for large portions of his life and

1 ultimately, after a great deal of struggle, was actually  
2 able to capitalize on a lot of the strengths that he  
3 developed as a result of it.

4 But I'm not asking you about your educational  
5 product. I'm asking you about your business decisions.  
6 You had this product in a non-profit organization. You  
7 entertained at least -- counsel indicated, up to 20  
8 different folks that had an interest in distribution but  
9 at some point, you ended up in a conversation with Mr.  
10 Morrow in Florida.

11 Why did you decide to continue the discussion  
12 with Mr. Morrow rather than the other distributors?

13 MR. McCABE: Oh. Those were distributors,  
14 not -- they were in the business of distributing from  
15 many, many publishers.

16 THE COURT: Yes.

17 MR. McCABE: Now, he put on a great presentation  
18 to me and I believed basically his presentation which,  
19 when I saw on --

20 MS. WOODROW: TV. Osgood?

21 MR. McCABE: On the --

22 MS. WOODROW: Charles Osgood show?

23 MR. McCABE: It was the -- what was the name.

24 MS. WOODROW: The TV show?

25 MR. McCABE: Yeah.

1 MS. WOODROW: Charles Osgood.

2 MR. McCABE: Charles Osgood. When I saw on --  
3 which you can watch right here, it's on --

4 MS. WOODROW: TV, ABC, I think. CBS. One of  
5 the national shows.

6 MR. McCABE: -- the CBS show, it was almost word  
7 for word, great presentation, and I believed him. I  
8 believed he could do what he said he could do.

9 MS. WOODROW: Mr. McCabe.

10 MR. McCABE: That he was --

11 MS. WOODROW: Mr. McCabe.

12 MR. McCABE: -- that he had an income in the low  
13 millions and even at that time, I said -- I told him and  
14 that's why I had the price rather low because just having  
15 an income of a few million does not compare to the big  
16 publishers.

17 THE COURT: Now --

18 MR. McCABE: I wanted him to really go with it,  
19 make money for himself and make money for the foundation.  
20 So the foundation could really do what I wanted it to do.  
21 We're not basically just a publisher or a printer. We  
22 had -- there is not a single book here that can be found  
23 anything like it anywhere.

24 MS. WOODROW: But --

25 THE COURT: Now, let's stop for a minute.



1 MS. WOODROW: Thank you.

2 THE COURT: Let's pick up with opposing counsel.

3 MS. WOODROW: Thank you, your Honor.

4 THE COURT: Let's talk about HSI and Mr. Morrow.

5 We've talked a little bit about Mr. McCabe. Tell me a

6 little bit about Mr. Morrow and HSI, sir.

7 MR. DI GIACOMO: HSH, your Honor, Home School

8 Holdings. Mr. Morrow was the CEO, president, I'm not

9 sure what the official title was. Was it CEO? CEO of

10 Home School Holdings at the time. Home School Holdings

11 was looking to acquire companies. It current -- it

12 previously had a product, I believe, that was --

13 THE COURT: Tell me a little bit more about Mr.

14 Morrow. How --

15 MR. DI GIACOMO: Sure.

16 THE COURT: How old a gentleman was he at the  
17 time, what was his educational and business experience?

18 MR. DI GIACOMO: I would let him speak to that,  
19 your Honor.

20 MR. MORROW: Your Honor, I met Don in May of  
21 2009 so I would have been 46 years old. My educational  
22 background is I have a BA and a MBA from the University  
23 of Illinois. My MBA focuses on finance.

24 THE COURT: From where?

25 MR. MORROW: From the University of Illinois,

1 Champaign-Urbana.

2 THE COURT: Champaign-Urbana. My wife got her  
3 Master's there. And after that, sir?

4 MR. MORROW: In terms of education?

5 THE COURT: Yes, sir.

6 MR. MORROW: In 1995, I completed my CFA, having  
7 passed in three consecutive tests and in 1999, I earned  
8 my CMA which is basically the cost accounting equivalency  
9 of a CPA.

10 THE COURT: Employed where?

11 MR. MORROW: When I first graduated from the  
12 University of Illinois, I was employed by Motorola,  
13 Incorporated. I worked in their Asia-Pacific cellular  
14 subscriber position until 1995. From 1995 until 1997, I  
15 contracted technology jobs. I had wanted to learn about  
16 the web and enterprise applications so I did some work in  
17 that area.

18 THE COURT: Technical side or finance side?

19 MR. MORROW: Technical, sir.

20 THE COURT: How did you develop those skills?

21 MR. MORROW: While I was at Motorola, someone  
22 had to do the digitization of some of our processes  
23 specifically related to things like sales forecasting,  
24 things like that that are extremely important when you're  
25 in an industry like cellular. We actually digitized that

1 using Motorola's propriety technologies. It worked very  
2 well.

3 But I really found I had a strong interest in  
4 that so I spent the next two years doing contract work  
5 for companies like Coca-Cola, CNA Insurance, places like  
6 that.

7 In July of 1997, a group of three executives  
8 that were about to start an energy marketing company  
9 called People's Energy Services contacted me because they  
10 wanted a CFO who was very tech savvy because in the  
11 energy industry, the margins are very narrow and you've  
12 got to make sure that you squeeze every penny out of  
13 every dollar. So for two years, I was the CFO there.

14 THE COURT: And the name of that again was?

15 MR. MORROW: People's Energy Services. Our  
16 largest equity investor was People's Energy Corporation  
17 which you may have heard of. It was recently acquired by  
18 Wisconsin Public Service. That company we created is  
19 still a division of Wisconsin Public Service as something  
20 north of a billion dollars in sales now.

21 THE COURT: You were there approximately two  
22 years?

23 MR. MORROW: Just about exactly two years, sir.

24 THE COURT: And then where?

25 MR. MORROW: From there, I contracted with

1 Arthur Andersen which was kind of bad timing in that  
2 regard and I served as a CFO for a start-up called  
3 Preview Port. Preview Port unfortunately came to an end  
4 when its founder died suddenly of brain cancer.

5 MS. WOODROW: I'm sorry?

6 MR. MORROW: Preview Port.

7 MS. WOODROW: Okay.

8 MR. MORROW: I then worked in the effort to  
9 build what was called a graduate facility for the  
10 Illinois Medical District. It's a -- I don't know how  
11 familiar you are with the incubation of start-ups, your  
12 Honor, but start-ups, typically when they are very small,  
13 they go into what's called an incubator where they are  
14 supported by either the state or by a foundation which  
15 provides them office space and technical support and all  
16 those kinds of things.

17 And then when they start to get sales and  
18 they're a little larger but not really ready to be  
19 independent yet, they move into a graduate facility. The  
20 IMD didn't have a graduate facility. They wanted to  
21 build one but they couldn't afford to fund one so for two  
22 years, a partner and I worked on the attempt to raise  
23 funds to build a graduate facility for the IMD. We ended  
24 up coming very, very close to getting it done but the  
25 deal fell through at the last second which was very

1 disappointing.

2 THE COURT: Who was going to fund it?

3 MR. MORROW: Excuse me?

4 THE COURT: Who was going to fund it?

5 MR. MORROW: Cousins Properties out of Atlanta  
6 was our largest equity provider. It was slated to be  
7 built in the City of North Chicago which is, as the name  
8 says, north of Chicago. It's where Abbott Labs is.  
9 You're probably familiar with Abbott Labs.

10 The piece of land that we would have acquired to  
11 build this facility is just across the street from Abbott  
12 Labs. The County of Lake was a participant, the City  
13 of North Chicago was a participant until they withdrew  
14 and sank the deal and the State of Illinois and the  
15 federal government both would have participated at a  
16 certain level.

17 THE COURT: Offered explanation for withdrawing  
18 funding?

19 MR. MORROW: North Chicago was -- it was and is  
20 a city that's struggling. It's a very poor city. They  
21 are one of those cities that is somewhat similar to  
22 Flint, that had a lot of industry and lost it. Basically  
23 all that remained in North Chicago was the presence of  
24 Great Lakes Naval Training Center. That's the only big  
25 industry that remains but there used to be a lot of heavy

1 industry, specifically metal banding type industries,  
2 brass foundries, steel foundries, that sort thing.

3 As soon as they saw that Cousins Properties was  
4 happy to come in, they decided they didn't need to put  
5 their six million dollars in anymore. That angered  
6 Cousins so much, they withdrew their participation  
7 because as it was such a narrow profit margin to begin  
8 with, Cousins' primary motivation of getting involved was  
9 an opportunity to get into the business.

10 Cousins was very big in strip malls and other  
11 large resale developments but they wanted to get into, at  
12 the time, biotech space was very profitable and a lot of  
13 it was being built. They saw this as a way to get into  
14 that side of the business.

15 THE COURT: So what do you do when it blows up?

16 MR. MORROW: You get very depressed. I spent  
17 two years working with the Salvation Army as their  
18 director of audit. It was a nice time for me to kind of  
19 recover emotionally from that disappointment and to do a  
20 lot of good work for a christian organization.

21 It was very nice because at the time, they were  
22 going through a financial restructuring because that  
23 division of the Salvation Army was really struggling  
24 financially. I can say quite happily and proudly that we  
25 did turn it around and that their finances were on a

1 sound footing when I left to form Home School  
2 Incorporated which became Home School Holdings.

3 THE COURT: And that would have been  
4 approximately what period of time?

5 MR. MORROW: That would have been July of 2006.

6 THE COURT: Tell us about HS -- counsel  
7 corrected me here, HSI.

8 MR. MORROW: HSI was the original corporation  
9 formed in October of 2005. I joined it permanently in  
10 July of 2006. Our goal was to create a one-stop shop  
11 where home-educated families could get all the resources  
12 they needed to successfully educate their children.

13 THE COURT: What was HSI? Was it a for profit  
14 enterprise?

15 MR. MORROW: Yes, sir. It was Delaware C.

16 THE COURT: Delaware C. Who were the equity  
17 participants?

18 MR. MORROW: The original founders were myself  
19 and David Nicholson who is here in the courtroom.

20 THE COURT: Relative equity holdings as between  
21 you and David?

22 MR. MORROW: Seventy-two/twenty-eight, naming me  
23 first.

24 THE COURT: David was 28.

25 MR. MORROW: Correct.

1 THE COURT: You were 72. How did you happen to  
2 choose that?

3 MR. MORROW: Um, somewhat arbitrarily, your  
4 Honor. We had worked together to fund another start-up  
5 that tried to do something similar a little earlier and  
6 it had -- it had not gone anywhere and we closed that  
7 effort down so we kind of based it on to what we  
8 contributed to the earlier effort.

9 THE COURT: What kind of capital funding did it  
10 require?

11 MR. MORROW: Originally, about \$100,000.

12 THE COURT: And how did you raise the money?

13 MR. MORROW: It was by my personal funds and  
14 David's personal funds.

15 THE COURT: Roughly seventy-eight thousand of  
16 your funds and twenty-eight of David's?

17 MR. MORROW: It was a little higher, probably  
18 about 75/25 but we negotiated down to 72 and 28.

19 THE COURT: How do things go in 2006, 2007?

20 MR. MORROW: It was very, very slow and very  
21 difficult.

22 THE COURT: Tell me what your business objective  
23 was.

24 MR. MORROW: Our business objective was to  
25 create an online presence that would enable people to



1 purchase all the curriculum and services they needed  
2 online as opposed, for example, of going to a bookstore.

3 We also provided -- intended to provide  
4 services, home education is a legally-regulated activity  
5 so -- and the law is very, very different state by state  
6 so for example, to provide legal resources.

7 The first project we undertook was called PER.  
8 We developed an online organizational tool that would  
9 allow parents to schedule their children's instruction  
10 but then also use that as documentation that they could  
11 provide to the state in those states that require the  
12 documentation of activities, materials used, time spent,  
13 sometimes referred to seat hours, et cetera.

14 When we first launched PER, it was very  
15 successful. We brought it out in January of 2007.  
16 Before 2007 was over, we had more than 36,000 users of it  
17 worldwide. We had them in all 50 states of the United  
18 States, every province of Canada and I think 44 foreign  
19 countries. We offered that free as the enticement to get  
20 people to come in and purchase from us.

21 THE COURT: And what was the title of the  
22 product that you branded it with?

23 MR. MORROW: It was called PER, sir, stands for  
24 Plan, Educate, Record.

25 THE COURT: And not unusually, you didn't charge

1 for the utilization of the product, correct?

2 MR. MORROW: Correct.

3 THE COURT: But how does the business model  
4 work?

5 MR. MORROW: The goal was to -- once we had them  
6 on our site, we also would present them -- we also  
7 presented an online store where they could purchase -- I  
8 think, when we first built it, we had 36,000 different  
9 items that we used by drop shipping through STL and, I  
10 can't remember the other name of the other distributor we  
11 used. We also sold advertising, obviously, like a great  
12 many online locations do.

13 But our primary goal was to, by enticing people  
14 in, we would sell them materials they needed. We tended  
15 to offer them as a very, very, competitive price. It's a  
16 very simple model, really, very common to the web where  
17 you draw someone in with a free application and then you  
18 sell them some other service or a product.

19 THE COURT: What kind of revenue in 2007?

20 MR. MORROW: I think we must have had something  
21 like \$50,000. We really struggled, your Honor.

22 THE COURT: That's gross rev.

23 MR. MORROW: Yes, sir.

24 THE COURT: 2008?

25 MR. MORROW: Um, I would say probably may have

1   gone to 90 or so. It's still quite light.

2           THE COURT: Does HSI need more working capital  
3   in 2007 and eight?

4           MR. MORROW: Yes. We were continuously drawing  
5   in capital, your Honor.

6           THE COURT: So how do you raise working capital?

7           MR. MORROW: I'm sorry, sir?

8           THE COURT: How do you raise working capital?

9           MR. MORROW: We approached individual investors  
10  most of whom were accredited investors. This is where  
11  Mr. Nicholson and his partner, Mr. Lydecker, were  
12  especially effective because they have a lot of  
13  relationships with well-to-do people. Very, very typical  
14  start-up story. The friends and family were large  
15  contributors.

16          THE COURT: And how did you manage the  
17  investment transactions? Were these exempt -- exempt  
18  from securities registration?

19          MR. MORROW: Yes, sir. Each investor, when they  
20  expressed an interest in investing, was provided a  
21  subscription agreement which they were required to sign.  
22  We kept a subscription agreement on record for each and  
23  every investor who came to us. Once we -- once an  
24  investor joined the company, they received quarterly  
25  reports that included financials. That's how we managed

1 our investors.

2 THE COURT: Had you expanded the board of  
3 directors as you sought out additional private investors?

4 MR. MORROW: Yes.

5 THE COURT: And who became involved in your  
6 board?

7 MR. MORROW: Yes, sir. Obviously, Dave and I  
8 were the sole directors at the founding of the company.  
9 In March of 2006, his partner Ken Lydecker joined the  
10 board. Shortly thereafter --

11 THE COURT: What was Lydecker's first name?

12 MR. MORROW: Kenneth. Shortly thereafter, a  
13 securities attorney who worked with me on the IMD  
14 project, by the name of Chris Davies, joined our board.  
15 And that size of four was a good -- a good workable  
16 size.

17 THE COURT: Four people.

18 MR. MORROW: Correct.

19 THE COURT: I've not had a chance to go through  
20 the exhibits but I note, for example, we've got HSI.

21 What is HSH?

22 MR. MORROW: HSH is a Florida C that was formed  
23 when HSI and Narayan Capital Corp merged. Chris Davies,  
24 our board member who is also a securities attorney, had  
25 strongly advocated that since we were having a very

1 difficult time raising large amounts of capital, which  
2 would have clearly facilitated the development of the  
3 company, he had suggested and had a great deal of  
4 experience in taking very small companies into the public  
5 markets, not the -- the bulletin board as opposed to the  
6 pink sheets, and used that method with parties with whom  
7 he had worked with several times to raise large amounts  
8 of capital.

9           Our challenge had been continuously, we always  
10 had a little money and we really needed a time when we  
11 had enough money where we could plan forward and execute  
12 on more difficult larger projects.

13           THE COURT: And what was the equity holding of  
14 HSH, wholly-owned affiliate by HSI?

15           MR. MORROW: Yes -- the other way around, HSI  
16 was a wholly-owned of HSH.

17           THE COURT: So you and David contributed your  
18 stock together with any of the other private investors  
19 that you picked up along the way to -- essentially, it  
20 would have been an exchange of HSH stock for HSI.

21           MR. MORROW: That's correct, sir.

22           THE COURT: At the time you created HSI, what --  
23 how much had your stock holding and David's stock holding  
24 been diluted by the addition of additional equity  
25 participants?

1 MR. MORROW: At the time of the HSH transition?

2 THE COURT: Yes.

3 MR. MORROW: I was down to, I think, 51 or 52.

4 I think Dave was down to 16 or 18 and -- and just so that  
5 you fully understand, we had contributed additional  
6 capital ourselves since then so the actual delusion from  
7 the original investment was considerable.

8 THE COURT: Had you borrowed money or did you  
9 have some savings?

10 MR. MORROW: I had some savings and I borrowed  
11 some funds, also, from members of my family.

12 THE COURT: Did the four-person board for HSH  
13 also become a four-person board for HSI?

14 MR. MORROW: Other way around, your Honor. HSI  
15 became HSH, yes, you're correct.

16 THE COURT: Well, maybe I misunderstand the  
17 transaction. My understanding was that you created HSI  
18 and that it became the -- that HS --

19 MR. DI GIACOMO: HSH became the holding company,  
20 your Honor.

21 THE COURT: Yep, got it.

22 MR. MORROW: Okay.

23 THE COURT: But you essentially would have  
24 flip-flopped the board.

25 MR. MORROW: Yes.

1 THE COURT: They became the board for both  
2 entities.

3 MR. MORROW: Correct.

4 THE COURT: And how were you going to raise  
5 capital? What was the vehicle by which essentially  
6 creating a holding company enabled you to raise larger  
7 amounts of capital?

8 MR. MORROW: We had already made application to  
9 the SEC to become a public company and we had a five  
10 million dollar commitment from a company called Tangiers  
11 which was a hedge fund, that they would use to contribute  
12 once we would become a public company.

13 THE COURT: You obviously provided Tangiers with  
14 a business plan that A, required five million dollars and  
15 B, kept them in the game.

16 MR. MORROW: Correct.

17 THE COURT: What was it?

18 MR. MORROW: Our intention was, as I think as  
19 Don described quite accurately, was to acquire existing  
20 streams of revenue from existing product lines that had  
21 demonstrated their quality in the marketplace and to  
22 enrich them, in terms of their sales, but also to improve  
23 their value but combining them with other curricula to  
24 create a more comprehensive curriculum.

25 Our ultimate goal was to create a one-stop

1 curriculum where a parent could come, make one decision,  
2 purchase one package and have their entire curriculum.  
3 It's very similar to, your Honor, you may have heard the  
4 company K-12. It's very similar. They do the same  
5 thing. Sonlight which Don mentioned, uses the same  
6 thing. Timberdoodle does something sort of similar.  
7 There are several companies that do that and have been  
8 very successful at it.

9 THE COURT: Why did the business plan require  
10 five million dollars?

11 MR. MORROW: That was primarily for the  
12 acquisition of those existing product lines and a pretty  
13 strong advertising campaign. What we discovered early on  
14 was that the fact that we were not very effective in  
15 terms of promotion because we didn't have a lot of  
16 resources to promote was a real challenge for us so  
17 additional funds to ramp up that promotion would have  
18 been very useful.

19 THE COURT: And how was the transaction with  
20 Tangiers going to be structured?

21 MR. MORROW: It was structured -- they become  
22 equity investors, similar to everyone else. They would  
23 take the -- it was kind of, think of it as an IPO in slow  
24 motion, your Honor. In a typical IPO, Lehman Brothers or  
25 someone will just -- excuse me, will just drop a hundred



1 million shares on the market all in one day. Tangiers'  
2 plan was to drop ten thousand shares a day over the  
3 course of a year, that sort of process. So that as you  
4 can imagine, a very thinly-traded young stock doesn't  
5 suddenly lose all its value and then as they put it to  
6 the market, we would then receive the proceeds less their  
7 cut.

8 THE COURT: And you had gotten as far as putting  
9 together the IPO materials for registration?

10 MR. MORROW: That I do not know, your Honor. We  
11 had been in the S-1 process for a while and I don't know  
12 if you're familiar with it or not but we had gotten down  
13 to the point where we had six to nine comments on our  
14 comment letters so we were pretty close. But we never  
15 got past that six to nine hurdle and we were in  
16 registration something north of two years, your Honor.

17 THE COURT: Is Tangiers located in New York?

18 MR. MORROW: They are actually located in San  
19 Diego.

20 THE COURT: And how involved were they in the  
21 S-1 process?

22 MR. MORROW: Almost not at all, your Honor.

23 THE COURT: And what was the documentation of  
24 Tangiers' commitment to HSI?

25 MR. MORROW: HSH.

1 THE COURT: HSH, once you had completed the --  
2 once you had completed the S-1 process?

3 MR. MORROW: Actually, we already had an  
4 agreement that was about -- a placement agreement that  
5 was about this thick (indicating) so I didn't think there  
6 was going to be any additional documentation because we  
7 were public, because we had done it ahead of time, so  
8 everyone would understand what would happen once shares  
9 hit the market. We already had a market maker, Island  
10 Securities. We were already registered at FINRA so we  
11 had most of the bases covered, except getting past the  
12 SEC.

13 THE COURT: Was that the problem?

14 MR. MORROW: Yeah.

15 THE COURT: And what were the major comment  
16 problems that stalled the SEC?

17 MR. MORROW: We typically would get a comment or  
18 two on some of the more esoteric accounting issues.  
19 Other than that, they -- misprints, explain this idea  
20 further, those kinds of things. The SEC comments are  
21 somewhat interesting, your Honor. They can vary from,  
22 "You forgot to put a period on a sentence" to "We  
23 completely disbelieve what you've told us," and anything  
24 in between.

25 THE COURT: It nevertheless impacts Tangiers'

1 funding.

2 MR. MORROW: I don't believe so, your Honor,  
3 because I don't think they actually commit -- put --  
4 segregated some funds to commit to us. Their process  
5 allows them to use relatively little capital in order to  
6 manage because of an IPO in slow motion, it's not like  
7 with Lehman, Merrill Lynch, who has to have five hundred  
8 million dollars set aside.

9 THE COURT: They don't have to underwrite it.

10 MR. MORROW: Right. There's very little  
11 underwriting. It's not zero, your Honor, but it's a  
12 small number.

13 THE COURT: But the transaction is never  
14 completed.

15 MR. MORROW: No, sir.

16 THE COURT: Why did this one blow up?

17 MR. MORROW: I'm sorry, what was that?

18 THE COURT: Why did this one blow up?

19 MR. MORROW: We had gotten to the point where we  
20 had been in registration over two years. We thought it  
21 would be very valuable in dealing with the SEC to develop  
22 more significant revenue. We came to the point where  
23 we -- within the board, we just developed what we called  
24 the restructuring plan, sometimes also called the baby  
25 steps plan.

1           Our goal was to acquire one or two or three  
2 product lines that had significant -- not huge but  
3 significant sales so we could continue to fund the  
4 registration process but also start to generate and  
5 demonstrate more realistic revenue.

6           The problem was the restructuring plan had three  
7 elements, all three of which had to work. The first was  
8 the acquisition of the AVKO product line. It was  
9 important because, A, it provided cash flow. We expected  
10 it would be three hundred thousand. That's what we were  
11 told. And also give us a lot of credibility. We needed  
12 to get our --

13           THE COURT: What -- what due diligence had you  
14 done with respect to that representation?

15           MR. MORROW: We had actually sold Sequential  
16 Spelling as our product for several years. We requested  
17 financials of Don several times. He represented he  
18 didn't have them available or couldn't make them  
19 available. Given the small size of the product line and  
20 the structure of the offer we made him, I wasn't overly  
21 worried about it. The number he gave me seemed credible  
22 from what I knew about the market. If he told me he had  
23 a million dollars in sales, I would have had a much  
24 different response. There were concerns about that, your  
25 Honor. But I would never have guessed that the number

1 was one-third of what I was told.

2 THE COURT: Why did you like his product?

3 MR. MORROW: Your Honor, Don mentioned that we  
4 met at FPEA which is one -- it's about the second largest  
5 home school showing in the nation. When you talk to  
6 people about Sequential Spelling who are in home  
7 education, it's very well-known and it has a lot of  
8 people who really love it because it is a great product,  
9 a great product, and when you ask a user about it, they  
10 gush. They love it, it's a great product. My child  
11 could not learn to spell until he got this and now he can  
12 spell. And that was the kind of product I wanted to  
13 sell, was something that I could stand up in front of  
14 someone and be very proud to represent.

15 THE COURT: Now, the transaction with Tangiers  
16 and the problems with the registration statement --

17 MR. MORROW: Yes.

18 THE COURT: -- are occurring in summer of  
19 '06 -- no, they would actually have been continuing until  
20 '08.

21 MR. MORROW: It would have been in 2009, your  
22 Honor.

23 THE COURT: Okay.

24 MR. MORROW: We didn't start the registration  
25 process until we had been in existence 18 to 24 months.

1 THE COURT: You were permitted under your  
2 current comment period to continue to conduct business in  
3 the manner of acquiring intellectual property that AVKO  
4 presumptively had to sell.

5 MR. MORROW: Yes, your Honor.

6 THE COURT: How does that transaction get  
7 structured in June?

8 MR. MORROW: I had structured it so that I  
9 offered him one-sixth of the total in cash and  
10 five-sixths in stock. The shares were to be registered  
11 shares which is why we needed him to sign a subscription  
12 agreement. A registered share, as I'm sure your Honor  
13 knows, is one that can be sold publicly eventually once  
14 an entity becomes public.

15 THE COURT: It was a six hundred thousand dollar  
16 purchase price. The fifty was in cash. The  
17 representation would be in \$250,000 in marketable HSH  
18 stock?

19 MR. MORROW: Would be in stock that would become  
20 marketable once HSH would pass through registration,  
21 absolutely, yes, your Honor.

22 THE COURT: And the second stage to the  
23 transaction were an additional three hundred thousand  
24 would be paid.

25 MR. MORROW: Presuming that the transaction

1 achieved three hundred thousand in sales, we would do the  
2 same amount again. So another fifty thousand in cash and  
3 another two hundred fifty thousand in shares.

4 THE COURT: Any conditions?

5 MR. MORROW: Other than having to make three  
6 hundred thousand in sales, no, your Honor.

7 THE COURT: That was a condition --

8 MR. MORROW: That was the condition.

9 THE COURT: -- to the second -- to the second  
10 stage of the funding?

11 MR. MORROW: Correct.

12 THE COURT: To what extent did you explain to  
13 Mr. McCabe that you didn't have \$600,000, that you  
14 were -- that you were relying on the completion of the  
15 transaction with Tangiers and the IPO funding over a  
16 period of time?

17 MR. MORROW: Don and I actually had a relatively  
18 lengthy conference on September 22nd of 2009. He and his  
19 grandson Brian, who is the gentleman that is not here  
20 today, had gone through our S-1 the day before, so that  
21 he could see all the financials and he had some strong  
22 concerns which he made clear to me.

23 THE COURT: How did he get the S-1? Did you  
24 give it to him?

25 MR. MORROW: It was available online, your

1 Honor.

2 THE COURT: Sure, that part I understand but I  
3 guess my question is, had you printed a copy and  
4 furnished it to him so that he had an understanding for  
5 the way you intended to structure the transaction and his  
6 payment?

7 MR. MORROW: I had not provided him one at that  
8 time. Bearing in mind, your Honor, this is nine months  
9 before we did our transaction. We were still discussing  
10 the transaction at the time.

11 THE COURT: Okay. And by that, you mean your  
12 transaction with Mr. McCabe.

13 MR. MORROW: Correct.

14 THE COURT: Okay. What happens between then and  
15 June of 2010?

16 MR. MORROW: We were waiting for a time when we  
17 felt we were in a position to complete the transaction.  
18 As I've said, we were constantly having to manage our  
19 cash very closely and the \$50,000 payout wasn't -- I  
20 mean, we weren't yet ready to make that as opposed to do  
21 other things with the money like to continue to fund  
22 registration.

23 THE COURT: Lots happened in that time period,  
24 though. Lots of things happened.

25 MR. MORROW: We continued the registration. I



1 think we did three or four more S-1 comment letters.  
2 Raised more cash on a typical ongoing basis for us.  
3 Operationally, not a lot changed. It's about that time  
4 we started delivering the legal information on our  
5 website. That's about it. Other than that, we were  
6 really focused on getting the registration done.

7 THE COURT: Well, what would your balance sheet  
8 have looked like in early 2010? What -- what would it  
9 have reflected as -- what would it have reflected?

10 MR. MORROW: It looked like a young company that  
11 needed a lot of money. We were -- had significant  
12 accumulative deficit, clearly. We had significant debt  
13 but almost all of our debt was to internal parties, large  
14 shareholders. That's important because that's a second  
15 element of our restructuring plan, was that the large  
16 debt would be converted into equity before we proceeded  
17 into the slow motion IPO.

18 THE COURT: So in addition to the equity that  
19 you had sold to these investors, there came a point in  
20 time where you had to borrow additional sums from some of  
21 those folks.

22 MR. MORROW: Correct. Some elected to make  
23 their investments in the form of debt rather than equity.

24 THE COURT: And what kind of numbers are we  
25 talking about?

1           MR. MORROW: Somewhat north of a million, I  
2 would say, your Honor.

3           THE COURT: Not an insignificant sum of money.

4           MR. MORROW: No, sir.

5           THE COURT: And how is that working capital  
6 being used at that juncture?

7           MR. MORROW: Almost exclusively for continuing  
8 to operate the website and undertake the registration  
9 activities.

10          THE COURT: And how about compensation for you  
11 and David?

12          MR. MORROW: David was completely uncompensated  
13 other than a thousand dollars worth of shares a month in  
14 exchange for his service on the board. At that time, I  
15 was typically uncompensated in cash but I also received  
16 shares and the company accrued debt in the form of my --  
17 what would have been my cash portion of the -- of  
18 compensation.

19          THE COURT: I can remember back in practice when  
20 I would represent a client that didn't have anything  
21 other than a piece of art to contribute as a fee. My  
22 wife never liked to see me come home with a piece of art.  
23 She commented about the fact that it was hard to eat.  
24 You're in kind of an extreme set of circumstances at that  
25 juncture. This deal has got to close.

1 MR. MORROW: That's true, your Honor.

2 THE COURT: Mr. McCabe thinks that you're going  
3 to write him a check for \$50,000 and that you really do  
4 have stock with a market value of \$250,000. Is that a  
5 fair impression on his part? Or is it from your point of  
6 view, that you explained that you did not have that  
7 stock, that it did not have that market value, it was  
8 your hope that it would.

9 MR. MORROW: I would say half -- half of the --  
10 half of yes on the second one. We were, on an ongoing  
11 basis, still receiving investment so the way I conceived  
12 of it, your Honor, was that Don would simply be another  
13 one of those investors. Those investors had been making  
14 investments at a fixed price that we all accepted as the  
15 value of the shares based on the opportunity that existed  
16 before us. And you're absolutely right, it is difficult  
17 to eat until you get done with registration.

18 THE COURT: What happens between June 4 and July  
19 20 of 2010, to you?

20 MR. MORROW: To me personally? Our  
21 restructuring plan's three legs basically fell apart. As  
22 soon as Mr. McCabe refused to sign his subscription  
23 agreement, the second time, the deal with HSH is dead and  
24 unfortunately, because the acquisition of the AVKO  
25 product line was the linchpin in that restructuring plan,

1 the restructuring plan is dead.

2           Secondarily, the second leg of that  
3 restructuring plan was me lending the \$50,000 that we  
4 were using to pay it, to HSH so it could then pay Mr.  
5 McCabe his \$50,000.

6           THE COURT: But AVKO can't be the only  
7 revenue-producing venture that you've got at that stage,  
8 can it?

9           MR. MORROW: It would have been -- at \$300,000,  
10 it would have been the largest, your Honor, far and away.  
11 It was a very good opportunity for us.

12           THE COURT: But you're more than a couple  
13 million dollars into this project.

14           MR. MORROW: You're right, your Honor. In over  
15 the four years, we had probably put in 1.8 million  
16 dollars.

17           THE COURT: And depending on how you look at it,  
18 or higher, if you include both equity and debt.

19           MR. MORROW: That would I think would be equity  
20 and debt, your Honor. I'm not certain.

21           THE COURT: Okay. How many investors do you  
22 have breathing down your throat at that point?

23           MR. MORROW: Well, I was blessed, your Honor.  
24 None of them were breathing down my throat. We had 75  
25 investors, most of whom were related to a board member,

1 although about 20 were not.

2 THE COURT: Which board member?

3 MR. MORROW: Myself, Mr. Nicholson or Mr.  
4 Lydecker.

5 THE COURT: Again, what happens between June and  
6 July?

7 MR. MORROW: At that point, once the AVKO deal  
8 with HSH falls through, and my agreement with the board  
9 falls through, my CFO resigns which now means the third  
10 leg of the restructuring plan which is going through  
11 registration is now untenable. So at that time, I  
12 resigned. I take the deal to Don as Wave 3 and that's  
13 how we get here.

14 THE COURT: What -- what has occurred with  
15 respect to HSI and HSH?

16 MR. MORROW: In what regard, your Honor?

17 THE COURT: Chapter proceeding?

18 MR. MORROW: No. It's actually still operating.  
19 They still have advertising revenue, still exists, still  
20 presents PER to home educators.

21 THE COURT: Who is operating it?

22 MR. MORROW: A lady who worked for us then,  
23 is -- continues to operate the site. I'm not entirely  
24 familiar with the operational details, your Honor,  
25 because I've been out of it 19 months now, almost.

1 Or 18 months.

2 THE COURT: Where were you physically living at  
3 the time?

4 MR. MORROW: Arlington Heights, Illinois, your  
5 Honor. Still live there.

6 THE COURT: Nice drive.

7 MR. MORROW: It was, your Honor.

8 THE COURT: Well, by July, you and your wife,  
9 if I remember the pleadings correctly, had organized Wave  
10 3.

11 MR. MORROW: Correct.

12 THE COURT: And your idea was to see if you  
13 could bail out the transaction. Fair word?

14 MR. MORROW: Yes, sir.

15 THE COURT: I mean, it had failed with HSH and  
16 HSI, with Mr. McCabe.

17 MR. MORROW: Correct.

18 THE COURT: So what do you do in furtherance of  
19 that?

20 MR. MORROW: I offer Mr. McCabe shares in Wave  
21 3.

22 MR. DI GIACOMO: Can you discuss the meeting  
23 that you had with him at Tony's and the entire --

24 MR. MORROW: Don and I went out to lunch for  
25 the -- for the killer BLTs which he is very fond of.

1 THE COURT: I couldn't hear that, I'm sorry.

2 MR. MORROW: Mr. McCabe and I went out to  
3 lunch -- I came to visit him and he and I went out to  
4 lunch for the killer BLTs at Tony's because he likes  
5 them.

6 THE COURT: I still missed that. What was --

7 MR. DI GIACOMO: He said Tony's, your Honor,  
8 Tony's in Birch Run. The killer BLTs, your Honor.

9 MS. WOODROW: It has a pound of bacon on it.

10 THE COURT: All right.

11 MR. MORROW: At that point, I had to make it  
12 clear that -- he knew by then that HSH hadn't gone  
13 through because he didn't sign the subscription agreement  
14 but I had to make it clear that we had -- Wave 3 would  
15 now take over. I wanted to make sure that he felt  
16 comfortable that, you know, A, he is still going to get  
17 to retire, there would still be someone to take it over  
18 and keep it going, keep the product line going. And as  
19 far as I know, he agreed to that. He seemed comfortable  
20 with it. He said he would send a letter to HSH to  
21 finalize, just so you know, as far as I'm concerned,  
22 you're out of this and everything seemed agreeable and  
23 fine. He was paid his \$50,000. I bought \$25,000 of  
24 inventory and off we went.

25 THE COURT: What were you going to do in

1 particular for -- with the intellectual property that you  
2 were securing from AVKO? I've got to restudy that  
3 agreement again but may I understand that you anticipated  
4 printing and distributing?

5 MR. MORROW: We actually went further than that,  
6 your Honor.

7 MR. DI GIACOMO: Your Honor, I can -- I can talk  
8 about that. It was the right to distribute, the right to  
9 make derivative works. It was exclusive rights in the  
10 United States and a right of first refusal across the  
11 world. So it was essentially the equivalent of all the  
12 copyright rights under Section 106 of the Copyright Act.

13 THE COURT: Who had drafted that agreement?

14 MR. DI GIACOMO: Mr. Morrow did, I believe, your  
15 Honor.

16 MR. MORROW: Yes, your Honor. Don had said that  
17 he -- I had offered to have an attorney draft it and he  
18 didn't feel comfortable with that. He wanted a plain  
19 English agreement and in my unwisdom, I agreed to that.

20 THE COURT: Now, do we ever get a signed  
21 agreement by Mr. McCabe with W3, with Wave 3?

22 MR. MORROW: No, your Honor.

23 THE COURT: But you wrote him a check for  
24 \$50,000.

25 MR. MORROW: Correct, your Honor.



1 THE COURT: And presumably recorded that as a  
2 capital contribution to Wave 3.

3 MR. MORROW: Correct, your Honor.

4 THE COURT: Although it was probably written off  
5 a personal account.

6 MR. MORROW: Correct, your Honor, yes. Yeah,  
7 because Wave 3 didn't actually have a bank account at  
8 that time. I don't even know if it had come into  
9 existence quite yet.

10 THE COURT: Where had it been incorporated?

11 MR. MORROW: Nevada.

12 THE COURT: That's an interesting choice.

13 MR. MORROW: I got Delaware, Florida and Nevada  
14 covered now, sir.

15 MR. DI GIACOMO: I believe it's also registered  
16 as a foreign corporation operating within the State of  
17 Illinois, your Honor.

18 THE COURT: All right. But your client has no  
19 signed agreement. Was there a draft agreement?

20 MR. DI GIACOMO: There was a signed agreement.  
21 You know, I will let Mr. Morrow speak to that but there  
22 was a signed agreement on the HSH.

23 MR. MORROW: Under HSH.

24 MR. DI GIACOMO: The agreement was drafted but  
25 it was signed by Mr. Morrow. Even though the agreement

1 said HSH, the parties were essentially operating under  
2 the terms of the original HSH agreement.

3 THE COURT: That would have been the June 4  
4 document.

5 MR. DI GIACOMO: That's correct.

6 MR. MORROW: Right.

7 THE COURT: Was there a later --

8 MR. MORROW: And subsequent, there were two  
9 different drafts of a Wave 3 agreement, one of which  
10 spoke to providing shares in Wave 3. When that was  
11 rejected, then there was one that was written with  
12 providing a note.

13 MR. DI GIACOMO: And Mr. McCabe rejected both of  
14 those agreements. He believed that had he accepted a  
15 promissory note or had he accepted shares in Wave 3  
16 Learning, he would be subjected to some sort of  
17 liability.

18 THE COURT: Miss Woodrow, you sued HSI.

19 MS. WOODROW: I --

20 THE COURT: You sued HSI?

21 MS. WOODROW: I didn't know how the players all  
22 were interrelated at that time. Essentially, HSI no  
23 longer exists and HSH is floundering.

24 THE COURT: I guess my question is, do we have  
25 default judgments based on the original June 4 agreement?

1 MS. WOODROW: No. There is no default judgment  
2 against HSH.

3 THE COURT: Why not?

4 MS. WOODROW: Or HSI.

5 THE COURT: Why not?

6 MS. WOODROW: Because I do not believe the  
7 contract was actually between them. I do not believe it  
8 was actually -- that it was authorized by HSH and I have  
9 testimony in that regard.

10 MR. DI GIACOMO: Your Honor, we have proposed a  
11 consent judgment. We have not received any response on  
12 that proposal. We -- from our perspective, we do need to  
13 find a way to deal with HSH and HSI because we don't know  
14 the status of them and I believe that plaintiff's counsel  
15 has been in contact with them. We have not.

16 THE COURT: Well, but I guess what I'm getting  
17 at is, do you believe that HSH and HSI, are contractually  
18 responsible to your client?

19 MS. WOODROW: No.

20 THE COURT: Are you simply raising their defense  
21 that perhaps that board didn't authorize this transaction  
22 and that Mr. Morrow was acting ultra vires?

23 MS. WOODROW: Yes.

24 THE COURT: How did you reach that opinion?

25 MS. WOODROW: Yes, I do. I think it was

1 intended. He intended it for many months. I think there  
2 is documents that we have that indicate that he was  
3 planning this for a long, long time.

4 MR. DI GIACOMO: Your Honor -- your Honor --

5 MS. WOODROW: May I -- may I speak, Mr. --

6 MR. DI GIACOMO: Please.

7 MS. WOODROW: Thank you, Mr. Di Giacomo. And  
8 he -- counsel has misrepresented the contract, the terms  
9 of the contract. They were not perpetual nor were they  
10 worldwide exclusive. They were only exclusive in the  
11 United States and Canada.

12 THE COURT: We will get to the weeds here.

13 MS. WOODROW: All right. So I just want to  
14 correct that misrepresentation.

15 MR. DI GIACOMO: Your Honor, just to speak on  
16 the HSI issue -- HSH, excuse me -- there was an  
17 authorized resolution from the board of directors of HSH.  
18 Mr. Morrow did have the authority to approach AVKO.  
19 There is an e-mail chain within the pleadings that we  
20 have filed for this hearing basically attesting to that  
21 fact.

22 So to the extent that somehow Mr. Morrow usurped  
23 corporate profit or somehow took advantage of the  
24 corporation of HSH is simply not the case and in fact, we  
25 don't have any pleadings at this point alleging that Mr.

1   Morrow did that.

2           THE COURT:   Well, then, what is your opinion  
3   with respect to HSI and -- I have to get used to the --  
4   HSH, legal obligation to Mr. McCabe?

5           MR. DI GIACOMO:   I can't speak as to that.   I  
6   don't know.   My opinion, I think --

7           THE COURT:   Your opinion, did your client  
8   acquire those rights?

9           MR. DI GIACOMO:   Sure.

10          THE COURT:   How?

11          MR. MORROW:   He resigned from the board of HSH  
12   and then proposed the deal to Mr. McCabe and then --

13          THE COURT:   Ended his equity in conjunction with  
14   his resignation.

15          MR. DI GIACOMO:   That's correct, yes.   He  
16   received, I believe, a payment of \$1,000.

17          THE COURT:   And then -- and then he received an  
18   assignment of whatever HSI or HSH's interest was in the  
19   AVKO agreement.

20          MR. DI GIACOMO:   No.   There was no assignment.  
21   There was a release.

22          THE COURT:   Wait.   So they do own it.

23          MR. DI GIACOMO:   I'm sorry?

24          THE COURT:   They do own it.

25          MR. DI GIACOMO:   HSH?

1 THE COURT: Yes.

2 MR. DI GIACOMO: It is our understanding they  
3 do not. I believe HSH has stated they rescinded the  
4 contract. That's why we don't know what the status  
5 of --

6 THE COURT: Show me -- show me any written  
7 document that would suggest a rescission of the agreement  
8 between AVKO and HSH or HSI or any document reflecting  
9 your client's acquisition of that agreement from them.

10 MR. DI GIACOMO: Your Honor, I cannot show you  
11 that. I simply do not -- there is no document  
12 establishing that. My --

13 THE COURT: So it's fair to say that they  
14 continue to own all the rights that AVKO granted to them  
15 in that intellectual property.

16 MR. DI GIACOMO: I think that would be fair to  
17 say.

18 THE COURT: And have a continuing legal  
19 obligation to Mr. McCabe under that agreement.

20 MR. DI GIACOMO: Your Honor, I think that would  
21 be fair to say but the plaintiff has represented to the  
22 Court that HSH does not own the works. The affidavit of  
23 Mr. Nicholson specifically attests to that fact. He  
24 specifically says HSH does not have any rights in the  
25 works and does not currently intend to enter into an

1 arrangement with AVKO.

2 THE COURT: Wait. Is that because your client,  
3 Mr. Morrow, was not authorized to enter into that  
4 transaction?

5 MR. DI GIACOMO: I -- you would have to ask Mr.  
6 Nicholson. I don't know what his affidavit is attesting  
7 to.

8 THE COURT: What was your client's opinion about  
9 their continuing interest and obligation under that  
10 contract when he formed an additional company and entered  
11 into negotiations essentially to try to duplicate that  
12 transaction?

13 MR. DI GIACOMO: My client had a conversation, I  
14 believe, with Mr. Nicholson internally as well as Mr.  
15 Lydecker, explaining to them that he was no longer going  
16 to fund HSH. He intended to resign from the board and he  
17 intended to move forward with the deal with Wave 3  
18 Learning. They were well aware of the fact that Mr.  
19 Morrow was going to undertake that effort.

20 MR. MORROW: At that point, your Honor, HSH  
21 could not enter into an agreement with Mr. McCabe and  
22 AVKO.

23 THE COURT: It had, though.

24 MR. MORROW: Pardon? We had a signed document  
25 but the problem was, we needed the second step which was

1 a signature on the subscription agreement. If he doesn't  
2 sign the subscription agreement, the securities attorneys  
3 will not attach the opinion to the S-1 that allows us to  
4 go through registration and the SEC will not recognize  
5 that S-1 without the opinion letter and further, FINRA  
6 would prevent you from issuing any shares into the public  
7 markets if you have any shareholders who have -- who lack  
8 a subscription agreement attached to the shares when they  
9 were private.

10 THE COURT: So from your point of view --

11 MR. MORROW: That deal was dead, your Honor.

12 THE COURT: Well, we had one document with Mr.  
13 McCabe's signature on it but not the complete transaction  
14 and the fact that it was an incomplete transaction was in  
15 fact, from your point of view, what created the problem  
16 with completing the registration.

17 MR. MORROW: Yes, sir.

18 THE COURT: The fact that he would not sign the  
19 subscription agreement after the other AVKO agreement had  
20 in fact been signed.

21 MR. MORROW: That's correct, your Honor. The  
22 lack of the subscription agreement makes it absolutely  
23 impossible for HSH to move forward.

24 MR. DI GIACOMO: And I believe, your Honor, the  
25 subscription agreement was revised twice to -- to attempt



1 to resolve Mr. McCabe's concerns with the language.

2 MR. MORROW: It was revised once.

3 MR. DI GIACOMO: Once.

4 MR. MORROW: On the second -- after the first  
5 revision which spoke to the use of the verb "purchase,"  
6 Mr. McCabe made it very clear that he had no intention of  
7 signing the subscription agreement in any form.

8 MR. DI GIACOMO: Mr. McCabe was worried about  
9 some undisclosed liability. At the time, he had  
10 represented he had an attorney advising him but we now  
11 believe upon information and belief that he did not have  
12 an attorney and that he probably didn't understand what  
13 the use of that language within the subscription  
14 agreement actually meant, your Honor.

15 THE COURT: Now, let's go back to Miss Woodrow.  
16 I want to get a better understanding. What -- you've  
17 identified Mr. McCabe as a plaintiff in the case.

18 MS. WOODROW: Yes, your Honor. Yes, your Honor.

19 THE COURT: But you've also told me that Mr.  
20 McCabe doesn't have any ownership interest in the  
21 copyrights. He's simply an officer of this tax exempt  
22 corporation. How is he hurt? Why do you have him in as  
23 a plaintiff?

24 MS. WOODROW: Because he was the author and at  
25 the time, he -- he is -- I believe -- are you still on

1 the board of directors?

2 MR. McCABE: Yes.

3 MS. WOODROW: And he is on the board of  
4 directors and I was unsure as to when he stopped being  
5 the director of AVKO.

6 THE COURT: Well, but --

7 MS. WOODROW: And I think he is hurt because I  
8 think he was going to be -- I think he was going to be  
9 running or managing a lot of the development of the new  
10 programs that they wanted to do with AVKO. But, your  
11 Honor --

12 THE COURT: AVKO --

13 MS. WOODROW: -- I have the documents to show  
14 there was no HSH --

15 THE COURT: AVKO is --

16 MS. WOODROW: -- written by Mr. Morrow.

17 THE COURT: AVKO is the party in interest.

18 MS. WOODROW: Pardon?

19 THE COURT: AVKO is the party in interest  
20 according to your explanation.

21 MS. WOODROW: Correct.

22 THE COURT: What entitlement, if any, would Mr.  
23 McCabe have financially from AVKO? Let's assume for  
24 purposes of discussion that rather than --

25 MS. WOODROW: As an employee?

1 THE COURT: -- a structured payment by HSH of  
2 the \$600,000, let's assume it was cash. What was he  
3 going to do with the money as an officer and director of  
4 AVKO?

5 MS. WOODROW: Mr. McCabe?

6 MR. McCABE: One of the things that we would  
7 have done almost immediately would be to purchase a camp  
8 because there is a camp not too far from --

9 MS. WOODROW: Headquarters.

10 MR. McCABE: -- our headquarters, where we would  
11 train teachers using students who are dyslexic and show  
12 them how to teach. That's just one of the things.

13 THE COURT: Why -- why do you have to own a  
14 camp --

15 MR. McCABE: Pardon?

16 THE COURT: Why do you have to own a camp in  
17 order to run a camp?

18 MR. McCABE: Well, we could have probably  
19 rented.

20 THE COURT: All right. You've \$500,000 left.  
21 What are you going to do? Was your intention to ever  
22 recover any of the money that you had invested, your  
23 pension funds and your wife's capital investment?

24 MR. McCABE: I know this sounds rather strange  
25 but really, there is only so many cases of beer that I

1 can consume. There is only so many rounds of golf. In  
2 fact, since I just quit my -- my golf club, I'm perfectly  
3 satisfied with my life for whatever I may have left of it  
4 and it's not too many -- too many years that I have, not  
5 with -- since I've already been informed there is  
6 absolutely nothing they can now do for me as far as  
7 surgery is concerned. I've had three heart attacks and  
8 open heart surgery and all of the tests show that the  
9 blockages -- and I even went to Cleveland Clinic. All  
10 they can do is treat me with medication. And hope for  
11 the best.

12 THE COURT: Now, let's assume for purposes of  
13 discussion that we back up the transaction. Wave 3 gets  
14 their \$50,000 back. I know that there is some additional  
15 investment that was made. What are you going to do --  
16 what is AVKO going to do? What's their business plan, if  
17 you get all this intellectual property back?

18 MR. McCABE: I object to you saying getting  
19 intellectual property back because I did not -- or the  
20 foundation did not sell any intellectual property.  
21 Publishing rights are entirely different than copyrights.  
22 Copyrights --

23 MR. DI GIACOMO: Your Honor, I object. This  
24 isn't a legal opinion. I know this is an informal  
25 hearing but just for the purposes of keeping the facts

1 straight --

2 THE COURT: I understand your point here and I  
3 do, and I appreciate that.

4 MS. WOODROW: Take it as his lay opinion, your  
5 Honor.

6 THE COURT: Right.

7 MR. McCABE: Okay. And I -- we can produce  
8 documentation in which Mr. Morrow tried to get a contract  
9 signed between IMI, AVKO and HSH in which he states that  
10 here -- whereas AVKO has the publishing rights -- or  
11 excuse me -- AVKO has the copyrights, and HSH has the  
12 publishing rights, he himself -- and I think it was in  
13 September of '09, that he -- he made the claim, so I  
14 think he knows there is a difference and if you check  
15 with Google and I have Googled and I have read the  
16 copyright law, to copyright something, you have to be the  
17 author and he's not the author of these. Or you can have  
18 it for hire and I'm sure he did not pay me one cent for  
19 these, for the writing of these, and I'm sure he cannot  
20 produce any document that was signed by the AVKO  
21 Foundation --

22 THE COURT: Sir, I --

23 MR. McCABE: -- saying -- saying, as I did  
24 myself to AVKO, I signed a regular transfer of copyrights  
25 to AVKO. AVKO never signed anything assigning the

1 copyrights.

2 THE COURT: Let's put aside the difference of  
3 opinion concerning copyrights versus publishing rights.  
4 Let's assume that you get back anything and everything,  
5 back into AVKO. What's AVKO going to do with it? What's  
6 your business plan?

7 MR. McCABE: Oh, well, first of all, since we  
8 lost actually three years of development, now, I'm -- I  
9 don't know what -- since I'm retired, you would have to  
10 ask my -- my son what he's -- who is the current  
11 director, and, of course, the president, Barry --

12 MR. ROBERT McCABE: Chute.

13 MR. McCABE: -- Barry Chute, what the plan will  
14 be. Because we have lost time, we have lost money and  
15 frankly, we don't have \$50,000 to give back.

16 THE COURT: Anybody else need to use the  
17 lavatory?

18 MR. DI GIACOMO: Yes, your Honor.

19 MR. MORROW: Yes, please, your Honor.

20 THE COURT: About a five-minute break and we  
21 will return, pick it up from this point forward.

22 Thank you.

23 MS. WOODROW: Thank you, your Honor.

24 THE LAW CLERK: All rise. Court is now in  
25 recess.

1 (At 10:48 a.m.- proceedings recessed)

2 (At 11:04 a.m. - proceedings resumed; all  
3 parties present)

4 THE COURT: I've been dodging a bullet and that  
5 is the appropriate pronunciation of your last name.

6 MR. DI GIACOMO: That's no problem, your Honor.  
7 It's Di Giacomo.

8 THE COURT: Di Giacomo.

9 MR. DI GIACOMO: That's correct.

10 THE COURT: You will correct me if I don't do so  
11 well going forward.

12 MR. DI GIACOMO: That's not a problem.

13 THE COURT: June -- July 20, 2010, Wave 3, by  
14 Mr. Morrow, suggests replacing what had been under the  
15 earlier, I'm going to say agreement with HSH, which was a  
16 promise to furnish a half million dollars worth of HSH  
17 stock. The offer makes the suggestion that you offer  
18 \$250,000 in the form of a promissory note.

19 MR. DI GIACOMO: That's correct, your Honor.

20 THE COURT: It doesn't go anywhere so at this  
21 juncture, Mr. Morrow doesn't have anything signed by Mr.  
22 McCabe other than a document that he had solicited in the  
23 name of HSH.

24 MR. DI GIACOMO: That's correct, your Honor.

25 THE COURT: So what does he do next?

1 MR. DI GIACOMO: Your Honor, next, he simply,  
2 basically asked Mr. McCabe, you know, what's the status?  
3 Mr. Mr. McCabe replied, let's just continue with the  
4 status quo, continue selling the works, continue  
5 repairing, I believe he said.

6 MR. MORROW: Get the ISPNS and get the revisions  
7 going.

8 MR. DI GIACOMO: Yes, get the ISPNS and the  
9 revisions going.

10 THE COURT: Could you speak from the microphone,  
11 sir? It would helpful to me because I couldn't hear.

12 MR. MORROW: I'm sorry, I'm too tall. He  
13 said -- he said get your ISPNS, which are your book  
14 registration numbers and get the revisions going and we  
15 will maintain the status quo.

16 THE COURT: What is status quo?

17 MR. MORROW: At the time, I was the person who  
18 was shipping the books. I was tasked with revising them.  
19 I paid him \$50,000. We didn't know what else was going  
20 to happen. That was the status quo.

21 THE COURT: Well, you tried to get him to agree  
22 to the promissory note. He wasn't agreeable to that.

23 MR. MORROW: Correct.

24 THE COURT: At the period -- what was the date  
25 of your \$50,000 check?



1 MR. MORROW: The 4th, I think, your Honor.

2 THE COURT: Sounds right. What are you using  
3 for working capital to, quote, "maintain the status quo"?

4 MR. MORROW: I had gotten additional funds that  
5 we used to both purchase the inventory and operate the  
6 business with going forward. In other words, the \$50,000  
7 wasn't the sum total of all the money I had in the world  
8 nor was the additional 25 for inventory. We had  
9 additional funds that we used to get the business  
10 started.

11 THE COURT: And what did you purchase?

12 MR. MORROW: From Mr. McCabe?

13 THE COURT: No, in terms of materials. I'm  
14 trying to get an understanding --

15 MR. MORROW: Oh, originally, I bought a chunk of  
16 his existing inventory which if you look at this nice  
17 display here, consisted mostly of those pieces in the  
18 middle there, you see with the bright covers  
19 (indicating). Those are the Sequential Spellings.  
20 Probably something like five or six thousand volumes,  
21 total.

22 MR. DI GIACOMO: What was the total amount of  
23 that, was it forty-two thousand?

24 MR. MORROW: No, twenty-five.

25 MR. DI GIACOMO: Twenty-five thousand.

1 MR. MORROW: Originally, Don had suggested it  
2 would be forty-two but it turned out to be twenty-five  
3 because he retained, if I remember from their 990,  
4 thirty-eight thousand of inventory themselves.

5 Besides the works, we didn't need to really  
6 purchase a whole lot to get started. The home education  
7 market is extremely seasonal, your Honor, and June, July,  
8 you're literally falling right into the middle of the  
9 season so at that point, there really isn't a whole lot  
10 of time to do anything but ship. We really started the  
11 revision activity, development activity, probably like in  
12 October once things have calmed down some.

13 THE COURT: Well, you've paid him \$50,000.

14 MR. MORROW: Yes, your Honor.

15 THE COURT: You're investing working capital in,  
16 was it -- did I get it correct, you've got five thousand  
17 to six thousand pieces that you've had printed?

18 MR. MORROW: Actually, Don had had them printed  
19 and he sold them to us out of his inventory.

20 THE COURT: Don had them printed and then what?

21 MR. MORROW: And then sold them to us. That's  
22 how we got started was inventory that he had provided.

23 THE COURT: Okay. Did you pay him anything  
24 other than the \$50,000?

25 MR. MORROW: Yes, I paid him \$25,000 for

1 inventory, your Honor.

2 MS. WOODROW: That was at cost, wasn't it?

3 MR. MORROW: Yes, it was.

4 MS. WOODROW: Thank you.

5 THE COURT: And this was beginning in the  
6 summer.

7 MR. MORROW: Yes, your Honor.

8 THE COURT: Describe for me where you think,  
9 what the status quo is.

10 MR. MORROW: The status quo to me, your Honor,  
11 was, I'm tasked to ship and fill orders. I'm tasked to  
12 get the revisions started, to get the new ISPNs because  
13 the acquisition of the intellectual property and my  
14 opinion, frankly, was that I was going to wait and let  
15 Don tell me what he wanted me to do.

16 We offered him two subscription agreements  
17 through HSH. He didn't want those. I offered him stock  
18 in Wave 3. He didn't want that. I offered him a note  
19 from Wave 3. He didn't want that. I have a pretty  
20 extensive imagination but that kind of exhausted my  
21 imagination for what was to go forward. So I was willing  
22 to wait for Don to tell me what he wanted to do. I asked  
23 him when he turned down the note to have -- for him and  
24 his attorney to write an alternative and they -- that  
25 never happened.

1           So status quo to me was, I'm shipping, I'm  
2 moving forward with the revisions. That's what I'm  
3 doing.

4           THE COURT: Mr. Di --

5           MR. DI GIACOMO: Di Giacomo, your Honor.

6           THE COURT: -- why shouldn't we issue the  
7 restraining order?

8           MR. DI GIACOMO: Your Honor, under the new  
9 merchant exchange, the test is no longer that irreparable  
10 harm is presumed from copyright infringement. Obviously,  
11 there are questions as to copyright infringement here.  
12 Whether that copyright infringement is done away with is  
13 an open question, obviously one for trial, but the fact  
14 that Mr. Morrow keeps accounting records, makes  
15 irreparable injury non-existent in this case because  
16 there is an adequate remedy at law which is monetary  
17 damages and we've always been forthcoming with those  
18 records. We provided sales records to the plaintiffs,  
19 both at the joint status conference, and we would be  
20 completely willing to continue to provide them.

21           And, you know, quite frankly, as you can see  
22 here, there is a lot of open issues. It's not simply a  
23 question of success on the merits but more of a question  
24 of how do we split the parties and at this point, it  
25 just simply would not be fair to make my client cease

1 selling these books which is his only sole form of  
2 revenue without the actual determination of the facts at  
3 issue.

4 THE COURT: Why do you think the distinction  
5 between -- that the plaintiff is attempting to draw  
6 between publishing rights and ownership -- copyright  
7 ownership rights is important?

8 MR. DI GIACOMO: I don't think there is a  
9 distinction between publishing rights and copyright  
10 rights. Copyright is the only right in a work of  
11 intellectual property like a book.

12 The question that I believe the plaintiff is  
13 getting at is, is this is a non-exclusive license or is  
14 this an assignment of copyright rights and under any  
15 scenario, there are still a lot of issues that need to be  
16 resolved that don't present the plaintiff with a  
17 likelihood of success on the merits, number one being, if  
18 we're going to split the parties, my client has invested  
19 a lot of time and money based on the representations of  
20 the plaintiff and, you know, how does he get that money  
21 back?

22 I think those types of issues lend towards a  
23 ruling, the necessary result of a ruling that a  
24 preliminary injunction should not issue at this stage  
25 because there is simply no likelihood of success on the

1 merits based on all of these remaining issues. And I  
2 think that, at the very least, there was an oral  
3 non-exclusive license which is permissible under the  
4 Copyright Act which would act as a complete defense to  
5 any claims of copyright infringement.

6 THE COURT: What's the nature of your cause of  
7 action in the counterclaim?

8 MR. DI GIACOMO: The nature of the cause of  
9 action is -- it's been a long time, I'm sorry, your  
10 Honor -- I believe we had a breach of contract claim  
11 which we removed for promissory estoppel because at the  
12 status conference, we discussed extensively that there  
13 wasn't a contract between Mr. Morrow and AVKO and in  
14 fact, it was probably more of a reliance relationship.  
15 So all of our causes of action are based around reliance  
16 damages.

17 THE COURT: We still have this unresolved issue  
18 with respect to HSI and HSH, the -- do we have any reason  
19 to believe that they have any legal interest in the  
20 contract that your client signed or any obligation to the  
21 plaintiff? And I assume your answer is probably I don't  
22 know.

23 MR. DI GIACOMO: It -- it is in a way but I  
24 don't believe -- I believe that HSH has completely  
25 disclaimed any rights to the works under the original

1 agreement. I believe both the plaintiff and HSH have --  
2 have made representations to the effect that neither  
3 party believes that a contract existed to the extent that  
4 the plaintiff has probably waived any claims against HSH.  
5 I don't know. I would like to see a consent judgment  
6 just clarifying that relationship. Again, I don't have  
7 contact with HSH so I'm not really sure how that would  
8 work out.

9 THE COURT: Including any right they might have  
10 to indemnity by your client as a result of what the  
11 plaintiff would allege was ultra vires activity.

12 MR. DI GIACOMO: That possibly could be but the  
13 plaintiff has not alleged that at this point. I'm not  
14 quite sure what the plaintiff is alleging with regard to  
15 HSH which has been my concern all along. I think that  
16 the allegation is expanding in scope without the proper  
17 pleadings laying the ground work.

18 We've requested a consent judgment or something  
19 along those lines so we could at least affirmatively  
20 respond in pleading form or motion form to those types of  
21 allegations but they are just simply not in the record at  
22 this point.

23 THE COURT: How do we -- how do we wrap up and  
24 how do we conclude what your point of view is with  
25 respect to these parties, Miss Woodrow?

1 MS. WOODROW: It is my contention that Mr.  
2 Morrow intended from the very -- from the very beginning  
3 or at least in January of 2010, to take over this  
4 contract and to take over this deal because he was hoping  
5 that after having a series -- he's a serial entrepreneur.  
6 Well, he's serial failed entrepreneur. Every -- every  
7 start-up he has had has voluntarily dissolved or just  
8 failed miserably and this is just another one in a  
9 series. He represented, I have documents --

10 THE COURT: I'm sure you made him feel very good  
11 about himself but --

12 MS. WOODROW: I'm sorry, sorry, sir, but it's  
13 just --

14 THE COURT: -- that does not ultimately answer  
15 my question.

16 MS. WOODROW: Okay.

17 THE COURT: You've had this lawsuit pending  
18 against a party who had executed the agreement, mainly  
19 Mr. Morrow, on behalf of these two other entities.

20 MS. WOODROW: Right, but he signed it  
21 fraudulently.

22 THE COURT: Does your client maintain a  
23 legitimate contract right against those parties?

24 MS. WOODROW: I do not believe so, between HSH,  
25 after having discovered --



1 THE COURT: Do you --

2 MS. WOODROW: -- HSI was absorbed by HSH so HSI  
3 does not exist. I did not know that at this time, when I  
4 filed the -- when I filed the pleading. I do now.

5 THE COURT: And --

6 MS. WOODROW: And therefore, I -- I can dismiss  
7 them. They haven't appeared so they really are  
8 non-entities. I can do a dismissal as to HSI.

9 THE COURT: Well --

10 MS. WOODROW: And I can do it --

11 THE COURT: -- why would you dismiss a lawsuit  
12 against the only entity that has an executed contract?

13 MS. WOODROW: HSI does not.

14 THE COURT: HSH does.

15 MS. WOODROW: HSH does.

16 THE COURT: And HSI is its successor.

17 MS. WOODROW: If they will remit over to us a  
18 cause of action for misappropriation, perhaps, by their  
19 officer and a violation of his code of ethics, but Mr.  
20 Morrow represented to my client that he was coming to do  
21 this as an individual --

22 THE COURT: Well, wait a minute.

23 MS. WOODROW: -- the day before the execution.

24 THE COURT: You just elected -- you just elected  
25 to characterize the transaction that Mr. Morrow conducted

1 as an unauthorized transaction.

2 MS. WOODROW: I believe it was.

3 THE COURT: Why are you telling me that rather  
4 than them telling me that? You represent this gentleman.  
5 Why wouldn't you sue them and either, A, take a default  
6 judgment or if they are willing to so characterize that  
7 transaction that way, maybe they will -- they will assign  
8 you the cause of action, I don't know, but we do not know  
9 what their characterization of that contract is or of Mr.  
10 Morrow's conduct. We don't know that.

11 And the case has been pending how long?

12 MR. DI GIACOMO: Seven months, your Honor.

13 MS. WOODROW: I will rely on -- July, August,  
14 probably, six, seven -- six months.

15 THE COURT: Now, let's back up. June 4 comes  
16 around. Mr. McCabe does not want to sign the  
17 subscription agreement. Which Mr. Morrow would suggest  
18 was both required and necessary for him to complete the  
19 registration statement.

20 MS. WOODROW: He is not told that and I don't  
21 believe that that -- I don't believe that that is  
22 accurate.

23 MR. DI GIACOMO: Your Honor --

24 MS. WOODROW: Just --

25 THE COURT: Pardon me?

1 MS. WOODROW: I don't believe that that is  
2 accurate, your Honor.

3 MR. DI GIACOMO: I just want to say, we have  
4 e-mail evidence establishing -- we have e-mail evidence  
5 establishing the fact that he was told that.

6 MS. WOODROW: I didn't understand what you --

7 MR. DI GIACOMO: He was told that the  
8 subscription agreement was necessary to complete the IPO.  
9 He was told that in an e-mail.

10 MS. WOODROW: I -- I didn't understand what you  
11 said.

12 THE COURT: He was told expressly that the  
13 execution of the subscription agreement was both required  
14 as a result of the written agreement he had already  
15 signed and necessary to the completion of the transaction  
16 leading to the --

17 MS. WOODROW: I would like to see his  
18 verification of that, your Honor, because he had already  
19 filed an \*HK in January with the SEC with a document, with  
20 a signature by Mr. McCabe, and a false note. So he had  
21 already filed something with the SEC on January 5th of  
22 2010.

23 I wish we had been allowed to have me call him  
24 as a witness and go through some cross-examination where  
25 he's under oath because he's made several

1 misrepresentations and lies here and there are others.

2 THE COURT: All right. And I appreciate that.

3 MS. WOODROW: Thank you, your Honor.

4 THE COURT: I've actually conducted this hearing  
5 in this fashion for a reason.

6 MS. WOODROW: I understand, okay. Thank you,  
7 your Honor. I'm sure you did and I'm not questioning  
8 your wisdom, I'm just, you know --

9 THE COURT: This is going to be kind of like an  
10 extended opening statement where we've got the  
11 participation of the parties --

12 MS. WOODROW: Okay.

13 THE COURT: -- without the disadvantage of  
14 anyone being under oath with the associated penalties.

15 MS. WOODROW: I've -- I've been in contact with  
16 HSH, with the -- the interim CEO, Mr. David Nicholson,  
17 who is here, who has told me that they withdrew their  
18 authorization prior to entering into the contract. Mr.  
19 Morrow sent an e-mail saying he was going to enter into  
20 the contract as an individual. Nevertheless, he signed  
21 it on behalf of HSH and I'm sure that once we leave here,  
22 there will be a -- some sort of an agreement between Mr.  
23 Nicholson and between AVKO -- between HSH and AVKO as to  
24 the assignment of any claims that might exist from HSH  
25 over to Mr. Morrow. That can be -- that will be done

1 within 30 days.

2 THE COURT: Okay. Now, let's talk about what  
3 happens after June 4.

4 MS. WOODROW: Yes. After --

5 THE COURT: Apparently, to use the language that  
6 Mr. Morrow said, when he had exhausted his efforts at  
7 getting the subscription agreement or promissory note  
8 signed --

9 MS. WOODROW: The subscription agreement  
10 required -- required Mr. McCabe to pay for the stock,  
11 number one. Number two, it required him to make  
12 representations that were not appropriate in the  
13 subscription agreement that he could afford to lose  
14 money, et cetera, et cetera, and that he was a certain  
15 type of a corporation or certain type of entity, that  
16 he could not make those representations on behalf of  
17 AVKO.

18 THE COURT: Okay.

19 MS. WOODROW: He couldn't sign it.

20 THE COURT: All right.

21 MS. WOODROW: He read the subscription  
22 agreement. He couldn't sign it either with or without  
23 the requirement to pay money. When he is selling the  
24 company --

25 THE COURT: He is, however, on the other hand,

1 quite willing to accept a check for \$50,000 and to accept  
2 a check for \$25,000 worth of inventory.

3 MS. WOODROW: Correct. Because --

4 THE COURT: With what contemplated obligation?  
5 He has all the money.

6 MS. WOODROW: He doesn't have all the money.

7 THE COURT: He has the fifty thousand and he has  
8 the twenty-five thousand.

9 MS. WOODROW: But he doesn't have the shares.  
10 He is expecting the IPO to go through and when the IPO  
11 goes through, then he is expected to be given -- AVKO is  
12 expected to be given \$250,000 worth of shares, they will  
13 turn right around and sell --

14 THE COURT: Wave 3 was going to go through the  
15 IPO?

16 MS. WOODROW: No, it was with -- he believed it  
17 was HSH. He was apparently --

18 THE COURT: Well, it's quite clear, he is told  
19 at that point that Mr. Morrow is out of HSH and HSI.

20 MS. WOODROW: That's -- HSH.

21 THE COURT: That he is organizing Wave 3, he  
22 wants to go forward with his best efforts to complete the  
23 transaction with that template.

24 MS. WOODROW: No, he does not complete a  
25 transaction with Wave 3. Never.

1 THE COURT: He wants -- he is told by Mr. Morrow  
2 that he would like to complete the transaction using that  
3 as a basic template.

4 MS. WOODROW: As far as Mr. -- as far as AVKO is  
5 concerned, AVKO has already performed. They gave all  
6 the -- they gave them everything. They performed fully  
7 on June 4th, when they gave them the inventory and when  
8 they gave them all of the disks and all of the --  
9 everything that they could publish, what they could use  
10 to publish, they performed a hundred percent. Their  
11 performance was done on June 4th and picking up the  
12 materials within the next week or so. Their performance  
13 has never been completed. Never.

14 THE COURT: Well, and what was it that they were  
15 to do?

16 MS. WOODROW: They were to -- he was to supply  
17 two hundred -- shares worth \$250,000 when it became an  
18 IPO. He registered -- he --

19 THE COURT: No, no, no. No. That was the  
20 earlier arrangement with HSH.

21 MS. WOODROW: There was no subsequent  
22 arrangement. There was no consideration for the  
23 subsequent arrangement with the Wave 3 Learning. AVKO  
24 doesn't care whether they -- what name they publish it  
25 under. They can publish it under Don Jones, \*Davy Jones'

1 Locker. It doesn't matter what name they publish it  
2 under.

3 As far as he knew, Mr. Morrow and/or HSH, he  
4 didn't know but somebody was going to publish them. He  
5 doesn't -- he didn't know what name or what they were  
6 going to do. They were just going to publish them. It's  
7 a ministerial task, like a secretary taking shorthand.

8 THE COURT: All right.

9 MS. WOODROW: It doesn't matter if she uses a  
10 blue book or a red book as long as she is taking  
11 shorthand.

12 THE COURT: But you've lost me again. Was the  
13 HSH and HSI transaction done and finished?

14 MS. WOODROW: From his perspective, he fully  
15 performed on June 4th. There was nothing for him to do  
16 with Wave 3 Learning. Wave 3 Learning is irrelevant to  
17 him.

18 MR. McCABE: It did not exist.

19 MS. WOODROW: It didn't exist on June 4th.  
20 Well, it did but nobody knew about it, only Mr. Morrow.  
21 He got a website for it in January while he was working  
22 for Home School. While he was a CEO for HSH, he went out  
23 and got a website for Wave 3 Learning under HSH. Then he  
24 took that website with him and formed the Wave 3 Learning  
25 once he had his hot little hands on his disks and his



1 materials of AVKO so that he could then begin to publish.

2 And AVKO turned everything over to them,  
3 everything. There was nothing more for them to do to  
4 perform. They had performed -- the contract was done as  
5 far as they were concerned.

6 All that had to be done to complete the  
7 performance of the contract was for Morrow to supply the  
8 \$250,000 worth of shares once it became an IPO and it was  
9 going to become an IPO -- he had a hundred forty-three  
10 million shares so if it comes up at a penny per, he is  
11 going to be able -- or half a cent per and they were  
12 still trying to get three hundred -- they started out  
13 trying to get fourteen million in the IPO, then it went  
14 to four point four million, then it went to three point  
15 three million and I don't know where the IPO is.

16 But it doesn't matter because he repudiated the  
17 contract when he sold his shares back to HSH. He could  
18 no longer perform. And he entered into the contract as  
19 an individual. He repudiated it because he sold his  
20 shares that he could have given him if it ever went on to  
21 be an IPO. If HSH continued and became an IPO, Morrow  
22 who was publishing would not have had the shares to pay  
23 him. That's a repudiation by conduct.

24 THE COURT: Okay.

25 MS. WOODROW: And therefore, he repudiated the

1 contract and he tried to replace it with another schmuck  
2 contract where he is going to get one-eighth of nothing.

3 THE COURT: Now, slow down, slow down.

4 MS. WOODROW: Yes, sir.

5 THE COURT: That's all right.

6 MS. WOODROW: Thank you.

7 THE COURT: What is your client owed by Wave 3?

8 MS. WOODROW: By Wave 3? Essentially, nothing.

9 He is owed by Morrow. Whoever -- whoever --

10 THE COURT: No, no, no, talk to your client.

11 MS. WOODROW: Okay.

12 MR. McCABE: Wave 3? We lost sales because we  
13 allowed them to publish and when they decided -- or Tom  
14 decided that -- that the onesie twosie, to quote him,  
15 sales were not worth his time, this is where we made our  
16 \$291,000 the year before, that he is quoting on, mostly,  
17 from onesie twosies, from individual home schoolers.

18 What he has done or didn't do, was to really  
19 market the materials. The fact that he only made  
20 whatever it was he says he made was his fault because he  
21 was a very poor publisher. I thought he was an  
22 entrepreneur. I thought he could do things because he  
23 did a great job of selling himself to me and, of course,  
24 to others that we can, of course, bring up to testify.

25 THE COURT: Now, here is my question. Does --

1 are you pursuing Mr. Morrow and Wave 3 for breach of  
2 contract?

3 MR. McCABE: Yes.

4 MS. WOODROW: There is no contract with Wave 3.  
5 There is a contract with Morrow or Morrow doing business  
6 as HSH.

7 THE COURT: All right. If there is no contract  
8 with Wave 3 --

9 MS. WOODROW: There is nothing written with Wave  
10 3.

11 THE COURT: Okay.

12 MS. WOODROW: There is no consideration.

13 THE COURT: All right. So we dismiss them.

14 MS. WOODROW: And the bottom line is, any monies  
15 that he spent, he had to have anticipated spending money  
16 to publish.

17 THE COURT: We can dismiss Wave 3.

18 MS. WOODROW: I don't care if -- it doesn't  
19 matter -- he may have chosen that vehicle. That was his  
20 choice to choose that vehicle to do the publishing, okay?  
21 He could have decided to do it in the basement. He could  
22 have decided to hire a company to do it. He could have  
23 published it on an Epson. He could have hired a printer.  
24 It doesn't matter. That was his bailiwick of how he was  
25 going to publish, was his business, and whether he chose

1 to do it through Wave 3 or whatever, we don't know.

2 We're just not sure -- he misrepresented that it  
3 was an HSH contract. It was a confusion. It was a  
4 structured confusion as many of his comments are  
5 structured confusion. If you read his LinkedIn, you read  
6 his resume, you read a lot of things, he says things that  
7 are not quite so. He says that People's Energy sought  
8 him out. They didn't. He walked into -- he went into a  
9 different interview and walked into that interview by  
10 mistake and they hired him. That's what he says in a  
11 document. So he misrepresents and he structures things  
12 and he says things to make people do what he wants them  
13 to do. He never once alerted Mr. McCabe that there was  
14 a -- at that time, a six million dollar deficit of HSH  
15 before he signed that contract.

16 THE COURT: Well, but, I'm -- what I'm getting  
17 at here --

18 MS. WOODROW: Yes.

19 THE COURT: -- is you already told me that you  
20 don't have a contract with HSH or HSI or if you do, you  
21 haven't elected to pursue it. You've told me that.

22 MS. WOODROW: I believe that --

23 THE COURT: You've told me --

24 MS. WOODROW: -- it was signed that way but I  
25 think it was a fraudulent signature.

1 THE COURT: You've told me --

2 MS. WOODROW: Yes.

3 THE COURT: -- that you don't have a cause of  
4 action against Wave 3 at least for a breach of an express  
5 written contract.

6 MS. WOODROW: Correct.

7 THE COURT: So you do have a cause of action  
8 against Mr. Morrow for breach of contract for failing to  
9 pay \$550,000.

10 MS. WOODROW: Actually, six hundred. It would  
11 have been two payments of \$300,000, which he contemplated  
12 and he verified in an e-mail, that it would be two  
13 \$300,000 payments.

14 THE COURT: Well, he has paid fifty.

15 MS. WOODROW: Pardon?

16 THE COURT: He paid fifty.

17 MS. WOODROW: He paid fifty but there is still  
18 some due and owing and by -- by voluntarily --

19 THE COURT: If -- if that is the case, you're  
20 entitled to your \$550,000 in the form of a judgment and  
21 he is entitled to continue to pursue the development of  
22 the works.

23 MS. WOODROW: If we sue for specific  
24 performance. However, by his repudiating the contract,  
25 we are accepting his repudiation of the contract.

1 THE COURT: Okay. So --

2 MS. WOODROW: And we have damages and we have  
3 lost profits.

4 THE COURT: -- rescission. Are you telling me  
5 that I disregard the allegation of a contract and breach  
6 of contract?

7 MS. WOODROW: I'm trying to plead in the  
8 alternative.

9 THE COURT: Well, no.

10 MS. WOODROW: Oh.

11 THE COURT: You can plead in the alternative but  
12 at some juncture, you have to decide.

13 MS. WOODROW: Yes, your Honor.

14 THE COURT: They are -- they are inconsistent  
15 remedies.

16 MS. WOODROW: Yes, they are, your Honor.

17 THE COURT: You are either enforcing a contract  
18 or you're unwinding a contract that never either existed  
19 or should have existed.

20 And whenever we talk about the concept of  
21 rescission, we have to talk about restitution.

22 MS. WOODROW: How about lost damages?

23 THE COURT: Well, wait a minute.

24 MS. WOODROW: Damages that were caused by --

25 THE COURT: You told me --

1 MS. WOODROW: -- repudiation of the contract.

2 THE COURT: You told me there was no contract.

3 MS. WOODROW: I think we have a contract that's  
4 been breached and the breach has caused damages to my  
5 client.

6 THE COURT: No, you just told me there was no  
7 contract.

8 MS. WOODROW: Between -- I think Morrow entered  
9 into a contract with them.

10 THE COURT: Well, then --

11 MS. WOODROW: Maybe a little --

12 THE COURT: Then you are ultimately entitled to  
13 a money judgment.

14 MS. WOODROW: All right.

15 THE COURT: Right?

16 MS. WOODROW: Yes, your Honor.

17 THE COURT: And you will get your money judgment  
18 for \$550,000 plus but he gets to keep and continue to  
19 develop the works. The breach of contract has been  
20 remedied by your judgment against him for the \$550,000  
21 but that doesn't mean that you get the money and the  
22 works.

23 MR. McCABE: Under the provision that he drop  
24 the claim to copyrights.

25 THE COURT: Well --

1 MS. WOODROW: And stops putting copyrights on  
2 the materials.

3 THE COURT: -- we have to do one of two things.  
4 There is only two things that I'm authorized to do. One  
5 is to unwind the transaction because it never existed  
6 or -- in which case, you give him back anything he gave  
7 you and he gives back anything he thinks you gave him.

8 MS. WOODROW: Is he not required to give back,  
9 also, the fruit of whatever he was given?

10 THE COURT: We will talk about that but I want  
11 to -- I want to get through the idea that we can't do two  
12 things.

13 MS. WOODROW: Right.

14 THE COURT: If there is a contract with Mr.  
15 Morrow/Wave 3, then you're not entitled to a restraining  
16 order because what you're entitled to is a judgment for  
17 \$550,000 and he gets to keep the works.

18 MS. WOODROW: The right to publish.

19 THE COURT: We can talk about that distinction  
20 later but let's -- let's make sure that we get an  
21 understanding for what the ground looks like from twenty  
22 thousand feet before we look at it from five. My point  
23 being that if you have a legitimate cause of action  
24 against Mr. Morrow and Wave 3, that he gets to keep  
25 whatever he bought and he's obligated to pay \$550,000.



1 MS. WOODROW: Additional.

2 THE COURT: That's what --

3 MS. WOODROW: Above and beyond the \$50,000  
4 that's already been paid.

5 THE COURT: Yes. Now, you can elect that  
6 remedy. You can elect that remedy.

7 The other remedy you can say is, oh, Ludington,  
8 there was never any agreement. What we need to do is  
9 unwind this transaction. Now, I fully acknowledge that  
10 my client needs to tender back anything that they  
11 received as equivalently as Mr. Morrow has to tender back  
12 what he got.

13 MS. WOODROW: Plus the profit from the use of  
14 that.

15 THE COURT: Now, he's, I'm sure, gotten filthy  
16 rich in the last two to three years on whatever he has  
17 done with that product. Now, Mr. McCabe is going to tell  
18 you that in that time period, they lost someplace between  
19 one hundred and three hundred thousand on what he could  
20 have done with Brian on the onesies twosies. He  
21 considers that a lost.

22 Well, just out of curiosity, how have things  
23 gone with respect to whatever you've been able to  
24 accomplish since June of 2010 through today's date with  
25 the quote "Continuation of the status quo"?

1           MR. DI GIACOMO: Your Honor, I want to address  
2 two points. One is Mr. Morrow's sales which he can  
3 attest to himself but also the fact that AVKO has been  
4 selling at the same time which slightly diminishes the  
5 market for the works and also is in violation of the  
6 contract if there is in fact a contract. If that's the  
7 position that the plaintiff wants to take, then that  
8 would be a violation of the contract because the contract  
9 actually states that AVKO can only sell the works to  
10 maintain their membership status as a 501c3 but I will  
11 let Mr. Morrow attest to the sales as to date.

12           MR. MORROW: Your Honor, in the year 2010, we  
13 had \$92,000 in sales. I do calendar years, not fiscal  
14 years like Don does. In the year 2011, we had \$128,000  
15 in sales. To date in January, we've had about \$5,200  
16 more in sales.

17           MR. DI GIACOMO: And Mr. Morrow, can you also  
18 explain what you've done to advertise the works because I  
19 believe that that's also at issue. AVKO's position,  
20 obviously, is that Mr. Morrow has not made these sales  
21 because he failed to advertise so can you shed some light  
22 on what you have done?

23           MR. MORROW: We have spent approximately \$17,000  
24 attending these home school shows. The shows that we  
25 attended had a grand total attendance of about seventy

1 thousand. These are typically recognized as the best way  
2 to reach home educators because opinion makers go to  
3 these shows.

4 MS. WOODROW: I'm having trouble hearing you.

5 MR. MORROW: I'm sorry. I will just hold this.  
6 That would be easier. Thank you.

7 We attended eight shows, your Honor, that were  
8 attended by a grand total of seventy thousand home  
9 educators. In the course of these shows, typically you  
10 get a chance to present directly to users, most valuable  
11 users who are opinion makers who go home and tell their  
12 friends and their co-ops and their organizations what it  
13 is they found. We found that extremely successful.

14 Getting to actually talk face-to-face, I would  
15 guess with something like twenty thousand current and  
16 potential users was much more effective than spending the  
17 same amount of money buying online ads on websites  
18 because it actually allows people to touch and feel the  
19 product. As you can see, it's very effective here.

20 MR. DI GIACOMO: Mr. Morrow, you bought ads on  
21 websites, is that correct?

22 MR. MORROW: I did not, no.

23 MS. WOODROW: Pardon?

24 MR. MORROW: No, I did not. No, it -- I have a  
25 great deal of experience in the online world, your Honor,

1 and in my experience, purchasing online ads is --

2 THE COURT: A waste of money.

3 MR. MORROW: -- worse than useless.

4 THE COURT: Okay.

5 MR. MORROW: It's similar to Mr. McCabe's point  
6 about the onesies twosies. He does wonderful things with  
7 onesies twosies. I actually sat there and figured -- I  
8 ran through his financials once and I guess he loses  
9 about \$20 for every onesie twosie he fills on a  
10 fully-loaded basis. This is me coming out as a cost  
11 accountant. I don't sell against my distributors which  
12 is why I don't do onesies twosies and the distributors  
13 are very happy about that.

14 MR. DI GIACOMO: Can you also speak to other --

15 THE COURT: We need to back up a little bit  
16 here.

17 MR. MORROW: Yes, sir.

18 THE COURT: Because I'm still trying to  
19 understand the characterization of both Mr. McCabe's  
20 cause of action, trying to figure out whether he is  
21 suggesting there was a contract that was breached and  
22 he's entitled to what he would have earned had the  
23 contract been performed or alternatively, there was a  
24 good effort at a contract, a mutual mistake of fact,  
25 possibly, and as a result, we need to unwind the

1 transaction.

2 MR. DI GIACOMO: Your Honor, pursuant to our  
3 status conference in October, we took the position that  
4 there was no contract and that the only appropriate  
5 remedy would be to split the parties and the reason we  
6 did that is because at the time the plaintiffs  
7 represented that that's what they wanted, that Robert  
8 McCabe was going to move forward with running AVKO and  
9 that they wanted to have nothing to do with our client.  
10 That's been our consistent position since then.

11 The confusion that you're seeing is the same  
12 confusion that we have and that is what do the plaintiffs  
13 want. We do not know so, you know, we can't -- we can  
14 respond to things that are within the pleadings but until  
15 we get a consistent picture of what exactly they want to  
16 do, we can't answer that question.

17 MR. MORROW: And we have made an offer of  
18 judgment that's consistent with the position that we have  
19 taken.

20 MR. DI GIACOMO: Which will be filed with the  
21 Court, your Honor.

22 THE COURT: But it can't be -- you can only file  
23 notice.

24 MR. DI GIACOMO: We -- we've given notice. The  
25 14 days will be up tomorrow.

1 THE COURT: But my point is that it's important  
2 that you not tell me what's in that offer.

3 MR. DI GIACOMO: I'm sorry. Mr. Morrow --

4 MR. MORROW: I beg your pardon, your Honor.

5 THE COURT: The fact that you have done it is  
6 something that I may know. The amount is something I may  
7 not.

8 MR. DI GIACOMO: And we will not speak to it.

9 THE COURT: The rule is written to the extent  
10 that I remain a finder of the fact in the context of the  
11 case, is I'm -- I'm to be left out of that discussion.

12 MR. DI GIACOMO: Understood, your Honor.

13 THE COURT: Now, to be sure, I've seen that set  
14 of circumstances occur. I've got a couple of cases  
15 sitting on my desk where there were very, very severe  
16 penalties as a result of refusals of offers of judgment.

17 I've got one case right now still spending where  
18 we're writing opinions where a party refused an offer of  
19 judgment for \$18,000. Case went to trial, spent five  
20 days with it. There were attorney fees in excess of  
21 \$98,000. The opposing party became responsible because  
22 they did not improve their position at trial and the  
23 question that we have in the context of that case,  
24 because the party that refused had to enter a Chapter 13  
25 bankruptcy proceeding, is whether or not we can continue

1 to make a decision as to whether or not the -- I won't  
2 involve you with the details of it because it's slightly  
3 irrelevant.

4 The point nevertheless being in the context of  
5 that circumstance, the refusal of the offer of judgment  
6 was sufficiently significant to require that party to  
7 seek chapter relief. They couldn't afford to pay the  
8 bill that was associated with continuing the dispute.

9 MS. WOODROW: We submitted an offer of judgment  
10 that they have refused, correct?

11 MR. DI GIACOMO: Your Honor, it was filed with  
12 the Court. I mean, I'm sure that you know the history.  
13 I believe that we refused it because we haven't answered  
14 it but it was filed with the Court prematurely. We were  
15 not provided with much notice. It was not within the 14  
16 days.

17 MS. WOODROW: I'm -- I'm sorry?

18 THE COURT: Now, let's -- let's back up here for  
19 just a moment.

20 MS. WOODROW: Did you -- did you reject the  
21 offer?

22 MR. DI GIACOMO: I don't know what the time  
23 period is. I believe we rejected it because we did not  
24 respond to it.

25 MS. WOODROW: I think you sent me an e-mail

1 rejecting it.

2 MR. DI GIACOMO: We -- we did but there was  
3 some clarification needed as to whether or not you were  
4 in a position to make the offer because you were not at  
5 the time a defendant which is what's required under the  
6 rule but in the alternative, if you are considered  
7 currently a defendant, then we did reject the offer.  
8 That's correct.

9 MS. WOODROW: Okay.

10 THE COURT: Following -- well, let's back up.  
11 I have one area of fact where I'm still not clear of what  
12 the allegations are.

13 Mr. McCabe, Mr. Morrow, says that after your  
14 effort to secure the subscription agreement from him, you  
15 never told him anything about Wave 3. He never told you,  
16 gosh, I understand -- I don't know exactly what to do,  
17 let's continue the status quo. That's what you told me  
18 but that's not what he says. What did he say? And when  
19 did he say it?

20 MR. MORROW: At the time I spoke to him, he said  
21 he was comfortable with that solution, that he would  
22 write a letter to HSH telling them that they were -- as  
23 far as he was concerned, that they were out of the deal.  
24 When they filed their 990 that October, he recognizes  
25 that he has a deal with Wave 3 Learning.



1           So if he didn't have a deal with Wave 3  
2 Learning, why did he tell the IRS that he did, I guess  
3 would be my question.

4           MR. DI GIACOMO: And, your Honor, he was also  
5 again presented with an agreement with Wave 3 Learning in  
6 that agreement. That was the point at which Mr. Morrow  
7 offered him a promissory note in exchange for -- or in  
8 substitution, excuse me, for the \$250,000. That  
9 agreement was titled Wave 3 Learning.

10          THE COURT: Is that true, Miss Woodrow?

11          MS. WOODROW: I'm sorry, I didn't --

12          THE COURT: Is that true?

13          MS. WOODROW: I didn't understand him.

14          MR. McCABE: I didn't see any promissory note  
15 offered to me.

16          THE COURT: Can you explain it one more time,  
17 Mr. Morrow, so Miss Woodrow can hear it?

18          MR. MORROW: Yes. When Don turned down the Wave  
19 3 Learning alternative agreement that said \$250,000 worth  
20 of shares, I offered the alternative suggestion that we  
21 convert the agreement into one that used a promissory  
22 note instead, in the same amount -- in the same dollar  
23 amount. At that time, he gave -- said, don't talk to me  
24 until you can give me an agreement I can sign. Let's go  
25 forward with the status quo. Go out and get your ISPNS

1 and begin to get the revisions.

2 MS. WOODROW: I believe that's somewhat  
3 accurate. I'm going to just check the e-mail. I've got  
4 the e-mail right here.

5 THE COURT: So we do have a contract with Wave  
6 3.

7 MS. WOODROW: Well, I don't -- maintaining the  
8 status quo, doesn't mean that -- maintaining the status  
9 quo means go ahead and do whatever you're going to do.

10 THE COURT: What does that mean?

11 MS. WOODROW: There was no -- the status quo  
12 would have been no agreement or whatever they were  
13 working on that was signed on June 4th. I believe that  
14 he believed that they were operating under the June 4th,  
15 2010 agreement and so did Mr. Morrow. He's referred to  
16 it in multiple e-mails throughout the year as referring  
17 to that's the agreement, the June 4th, 2010 agreement.

18 THE COURT: Why would he reject the promissory  
19 note if that was true?

20 MS. WOODROW: Pardon?

21 THE COURT: Why would he reject the promissory  
22 note if that was true?

23 MS. WOODROW: Because he can't pay. There is no  
24 proof that he can pay. He believed that -- did you not  
25 believe that HSH was going to go public and you would get

1 stock?

2 MR. McCABE: On June 4th, yes --

3 MS. WOODROW: Did you believe it in July?

4 MR. McCABE: -- and prior to that.

5 MS. WOODROW: Did you believe it in July when --  
6 did you ever have a reason to disbelieve that HSH was  
7 not? Did you -- did you know that Tom Morrow gave up his  
8 stock to HSH?

9 MR. McCABE: Ah --

10 MS. WOODROW: Until recently?

11 MR. McCABE: Not until quite -- quite a while  
12 after all of these events, when we began to look.

13 MS. WOODROW: When?

14 MR. McCABE: I'm not sure what date.

15 MS. WOODROW: Did you -- when did you know that  
16 HSH was not going to have an IPO? Did you ever know that  
17 until recently, until after we started the lawsuit?

18 MR. McCABE: Well, just before we started the  
19 lawsuit.

20 MS. WOODROW: Is that when you found out that  
21 HSH had retreated from their request for the IPO? So as  
22 far as you knew, the IPO was always a possibility.

23 MR. McCABE: Yes.

24 THE COURT: That doesn't make sense.

25 MR. DI GIACOMO: Your Honor, I believe that Mr.

1 McCabe's response to the promissory note was that he was  
2 worried he was going to become liable for debt of Wave 3  
3 Learning. I believe the response e-mail specifically  
4 states that.

5 THE COURT: What's important is there is a point  
6 at which -- someplace late in June or early July where  
7 Mr. Morrow has to go back to him, he has Wave 3  
8 organized. He has a promissory note that he wants him to  
9 accept as his next shot at figuring out how the  
10 transaction goes forward and he asks Mr. McCabe, how  
11 about the promissory note? It's -- the other transaction  
12 isn't going to work. I've left, I'm gone, right?

13 MR. MORROW: Correct, sir.

14 THE COURT: And what's he say?

15 MR. MORROW: He said he doesn't want an  
16 agreement that he can't sign. He doesn't want to become  
17 liable for the debts of Wave 3 so until I give him a  
18 contract that he can -- that he and his attorney believe  
19 they can sign, I should go forward with the status quo.

20 THE COURT: And what do you do in reliance on  
21 that statement?

22 MR. MORROW: At that point, I purchase  
23 inventory, I pay contractors to do revisions on the  
24 works, I pay to go to eight home school shows. I begin  
25 the development of iPad applications which are very

1 popular. I do all the things that one normally does  
2 when one is running a company and selling a product  
3 and that involves a pretty significant investment on my  
4 part.

5 THE COURT: Now, Miss Woodrow --

6 MS. WOODROW: Yes.

7 THE COURT: -- are we left with the question of  
8 going forward with a breach of contract allegation  
9 against Mr. Morrow and Wave 3? If so, I don't think  
10 you're entitled to your restraining order.

11 You're entitled to a damage remedy for  
12 essentially \$550,000 in AVKO's name against Wave 3 or Mr.  
13 Morrow and that's a detail that is of significance to him  
14 but for another day. Or are we going to unwind the  
15 transaction and elect a rescission and restitution  
16 remedy?

17 MS. WOODROW: If the issue of the damages  
18 caused -- well, the problem is, there are damages that  
19 have occurred in terms of the rescission by the  
20 misrepresentation and the fraud of the claimant. Not the  
21 claimant, excuse me, of Mr. Morrow, and I think we are  
22 entitled to some damages for that and I think they would  
23 offset -- I think they might offset each other so that  
24 frankly --

25 THE COURT: And let me suggest -- let me

1 suggest --

2 MS. WOODROW: -- if they would return the  
3 publishing rights to us, we pay them nothing, they pay us  
4 nothing, we all walk away, I think the clients would  
5 agree to that. I could get them to agree.

6 THE COURT: Let's stop for just a moment. Let's  
7 first of all recognize that we're going to jettison the  
8 contract enforcement action. We're going to elect  
9 rescission and restitution so that Mr. Morrow can go his  
10 way and AVKO can go its way, right?

11 MS. WOODROW: That would be -- I would have  
12 to -- I would ask for an opportunity to confer with the  
13 clients to let them make that decision and explain it to  
14 them.

15 THE COURT: So let's -- let's discuss what is  
16 involved in that. Let's start with Mr. McCabe's  
17 position. Mr. McCabe's position is that between June of  
18 2010 and whenever the case got filed --

19 MS. WOODROW: July of 2011.

20 THE COURT: -- because Mr. Morrow, in an  
21 unauthorized fashion, continued to market these -- these  
22 materials, he was deprived of a certain economic loss.  
23 He had, over the course of the prior years, since the  
24 early '80s, been able to raise someplace between eighty  
25 and \$291,000 dollars of revenue. I don't know what his

1 associated costs were.

2 MS. WOODROW: Correct. For the past three  
3 years, were I think two ninety-one and a little less than  
4 that, two sixty or something.

5 THE COURT: I think you're going to find that  
6 two ninety-one was your high.

7 MS. WOODROW: Absolutely, you betcha.

8 MR. DI GIACOMO: Your Honor, can I comment on  
9 that?

10 THE COURT: And that's also gross revenue. It's  
11 not net revenue.

12 MS. WOODROW: That is correct.

13 MR. DI GIACOMO: Your Honor, can I make one  
14 statement on that? The calculation of two ninety is  
15 membership fees as well which is -- has nothing to do  
16 with sales, as well as donations to AVKO the foundation.  
17 So the two ninety is not an accurate representation of  
18 sales in any way.

19 THE COURT: All right. As an example, let's  
20 just take that one year. Do you know what the breakdown  
21 is?

22 MR. DI GIACOMO: I don't have it in front of me  
23 but I can definitely get it to you. We've done it in  
24 the past. I believe we brought it to the status  
25 conference.

1 MR. MORROW: Your Honor, if I may speak, the --

2 MS. WOODROW: Yes, there were some  
3 significant -- there were some non-revenue, dealer  
4 revenue and non-dealer revenue.

5 THE COURT: What were your sales revenue in that  
6 year with the two ninety-one revenue?

7 MS. WOODROW: The year ending June 30, 2010, the  
8 dealer and non-dealer revenue was approximately one  
9 hundred twenty-nine dollars, six hundred eighty-five  
10 dollars, thirty-two cents.

11 THE COURT: I don't think that's right.

12 MS. WOODROW: Two hundred --

13 MR. McCABE: Let's add these two together.

14 MS. WOODROW: I am. Two hundred twenty-nine  
15 dollars, six hundred eighty-five dollars.

16 MR. McCABE: You mean two hundred twenty-nine  
17 thousand?

18 MS. WOODROW: Yes.

19 MR. McCABE: YOU said two hundred twenty-nine  
20 dollars.

21 MS. WOODROW: Oh, two hundred twenty-nine  
22 thousand, sorry about that. Trying to add at the same  
23 time.

24 THE COURT: And approximately what number did  
25 you arrive at?



1 MS. WOODROW: I'm sorry?

2 THE COURT: What was the number that you arrived  
3 at?

4 MS. WOODROW: All right. Two hundred --

5 THE COURT: Approximately.

6 MS. WOODROW: -- twenty-nine. Two hundred  
7 thirty thousand.

8 THE COURT: Two hundred thirty?

9 MS. WOODROW: Roughly, rounding it up.

10 THE COURT: And that was gross revenue?

11 MS. WOODROW: That would be gross revenue. We  
12 have returns of \$1,962.21.

13 THE COURT: So --

14 MS. WOODROW: There were donations.

15 THE COURT: -- Mr. McCabe's argument would be  
16 that there was some discernible loss that occurred to  
17 AVKO's revenue --

18 MS. WOODROW: Correct.

19 THE COURT: -- as a result of Mr. Morrow's  
20 involvement in the market.

21 MS. WOODROW: Yes.

22 THE COURT: Is your client, if he were to take  
23 the stand, going to say, go ahead with the status quo,  
24 make your best effort at proceeding to market the works?  
25 Is he going to say he didn't say that?

1 MS. WOODROW: He is not going to say that.

2 THE COURT: What's he going to say?

3 MS. WOODROW: I'm not going to let him say that  
4 because we have an e-mail where he did say that. What he  
5 meant by that, of course, I can't know, I can just only  
6 go with what the words say and --

7 MR. McCABE: Status quo at that time was the  
8 contract of June 4th, the only signed one, which had a  
9 lot of stipulations in it, including the -- hiring me to  
10 help with the development. Product development  
11 committee, he called it.

12 MR. DI GIACOMO: Your Honor, that was a  
13 permissory provision within the contract, if the contract  
14 was enforced. That wasn't a mandatory provision. It was  
15 that he can use Mr. McCabe --

16 MS. WOODROW: It was nice.

17 MR. McCABE: He used it to entice me to sign for  
18 AVKO.

19 THE COURT: Now, we have decided but we are not  
20 talking about contract enforcement here. We are talking  
21 about rescission.

22 MS. WOODROW: Right.

23 THE COURT: Right?

24 MS. WOODROW: The e-mail says:

25 "Until you can come up with an agreement

1           that my attorney can justify my signing, we  
2           had better just maintain the status quo."

3           THE COURT: Now, he says -- I understand Mr.  
4 McCabe's position here, which is that Mr. Morrow's  
5 continuing efforts may have had an impact on diminishing  
6 the amount of gross revenue that he would have earned  
7 during that period of time, but he told him to go ahead  
8 and he told him you're -- you're authorized to make some  
9 expenditures in continuing this business. Is he --

10          MS. WOODROW: He had --

11          THE COURT: Is he entitled to return --

12          MS. WOODROW: I do not believe so.

13          THE COURT: -- any of that net revenue, not  
14 necessarily gross revenue, as a result of his e-mail?

15          MS. WOODROW: No, he is not. Because in theory,  
16 you could look at it as a licensing. The \$50,000 was  
17 certainly a very small sum to pay as rental or use of the  
18 right to publish the materials from which he earned a  
19 couple hundred thousand dollars.

20          THE COURT: Gross revenue.

21          MS. WOODROW: Okay. He certainly had to have  
22 contemplated there would be expenses in publishing prior  
23 to his signing the contract on June 4th, 2010.

24          THE COURT: So what we're really down to, so far  
25 as you're concerned is, we're going to rescind the

1 transaction. Your client, AVKO, is ultimately going to  
2 receive all of the intellectual property that they might  
3 otherwise have received. A restraining order therefore  
4 would be appropriate.

5           You have in place a bond, as I recall, such that  
6 if --

7           MS. WOODROW: Not yet. We will get it.

8           THE COURT: Oh. Okay. Well, we will talk about  
9 that here in a minute.

10           Then the only remaining issue that -- issues  
11 that we've got in the context of the case are, how do we  
12 resolve the fact on the one hand that after Mr. McCabe  
13 said continue the status quo, his sales dropped because  
14 of what Mr. Morrow did, continued to participate in the  
15 market. And he would otherwise have earned that -- AVKO  
16 would otherwise have earned that amount of money.

17           Offsetting that, is Mr. Morrow saying, he told  
18 me status quo, continue to market this and I put  
19 additional money in and I need you to look at the fact  
20 that in reliance on his statement, I went ahead and did  
21 what I did and I would like something back for the fact  
22 that I did that in reliance on his statement.

23           We've got to offset those two arguments,  
24 right?

25           MS. WOODROW: No. He got the income from doing

1 that. He did not -- at no time did Morrow ever offer to  
2 return any and rescind the contract other than he  
3 repudiated it by conduct without telling anyone but he  
4 never rescinded the contract. He never said all right,  
5 if you won't sign this new agreement, I won't publish, I  
6 won't go forward. I want my money back. You get your  
7 property back, you can continue publishing yourself. He  
8 never did that.

9 THE COURT: You have, in the context of this  
10 case, said I'm electing my remedies.

11 MS. WOODROW: Okay.

12 THE COURT: Rescission and restitution.

13 MS. WOODROW: If we elect -- if we elect that  
14 remedy.

15 THE COURT: So we've agreed that rescission is  
16 what is appropriate. The only question is evaluating  
17 what the appropriate restitution is for the two parties.

18 MS. WOODROW: And there would be restitution for  
19 the loss of income from AVKO which would balance out the  
20 loss of expenses by Mr. Morrow.

21 THE COURT: All I'm suggesting to you is that  
22 we've got a defined time period, essentially June of 2010  
23 through whatever the -- well, say today's date, what  
24 AVKO's lost revenue is as a result of Mr. McCabe telling  
25 Mr. Morrow, let's continue the status quo. And that by

1 reason of that, anything that Morrow earned, he ought to  
2 get back.

3 Right?

4 MS. WOODROW: Right. Anything that Morrow  
5 earned, he should get back?

6 THE COURT: Mm-hmm. What if he didn't earn  
7 anything?

8 MS. WOODROW: What if he decided to buy a jet?

9 THE COURT: I'm willing to take the bet that he  
10 did not buy a jet.

11 MS. WOODROW: No, but I mean, I don't know  
12 that -- I don't think it is -- would be fair and I don't  
13 think it's appropriate because he did not use his  
14 advertised best efforts. Had he advertised more, he  
15 would have earned more.

16 THE COURT: You're talking contract -- you're  
17 talking contract enforcement. Now, my -- my point here  
18 is that we've got a fairly clearly defined period of  
19 time. We know that with the remedy that you've  
20 elected --

21 MS. WOODROW: If that's -- if that's the remedy  
22 that they choose.

23 THE COURT: They've agreed. You've said, we  
24 don't want contract enforcement. We don't want our  
25 judgment for \$550,000. We want our stuff back. So --

1 MS. WOODROW: And I don't know that -- I don't  
2 know that that's what the clients would like.

3 THE COURT: You need to talk with them.

4 MS. WOODROW: I would like to.

5 THE COURT: But remember --

6 MS. WOODROW: Yes.

7 THE COURT: -- that concomitant with that, would  
8 be the responsibility to at least pay back the \$50,000  
9 and what remains is a fairly simple equation and that is  
10 to make a determination of what AVKO may have lost as a  
11 result of the fact that Mr. McCabe told Mr. Morrow to go  
12 forward with the status quo, knowing that it was going to  
13 reduce his revenue on the one hand versus Mr. Morrow's  
14 countervailing argument which is, Mr. McCabe owes me  
15 something as a result of my own reliance damages because  
16 I invested additional capital, time and effort in trying  
17 to market this stuff and now he is telling me stop.  
18 We've got -- we've got to place values on those -- on  
19 those two different theories, right?

20 MS. WOODROW: Again, yes.

21 THE COURT: And part of -- part of our decision  
22 as to the propriety of those remedies is largely going to  
23 turn on the set of events that took place when Mr. Morrow  
24 left HSH and HSI, what he told Mr. McCabe, and whether  
25 Mr. McCabe agreed. And that really is kind of in a

1 nutshell all that really remains. Your client tenders  
2 the \$50,000. We have an open question on what we do with  
3 the \$25,000 that I believe --

4 MR. McCABE: He made money on.

5 THE COURT: He may have. I'm not disputing  
6 that. What we're looking at is an accounting time period  
7 that's fairly narrow. And today, we've only talked in  
8 gross numbers, not net numbers. Our net numbers are  
9 going to get -- are going to be contracted, they are  
10 going to be smaller. As an example, you may have had  
11 \$230,000 of gross revenue but you've got some offsetting  
12 expenses that were avoided more likely than not in  
13 conjunction with the fact that he was producing that  
14 revenue.

15 MR. McCABE: May I speak to that?

16 THE COURT: Sure.

17 MR. McCABE: The expenses operating the  
18 foundation would remain -- have remained the same.

19 THE COURT: Mm-hmm.

20 MR. McCABE: So the -- we did lose the -- all of  
21 those sales to the dealership -- to the dealers and  
22 that's at least, dropping it down to the gross profit,  
23 minimum of \$62,000.

24 THE COURT: Over that time period.

25 MR. McCABE: That's just over that one year.



1 THE COURT: Is that a gross revenue?

2 MR. McCABE: That would be over 2010.

3 THE COURT: Is that gross or net?

4 MR. McCABE: That's the gross profit. The  
5 expenses --

6 MS. WOODROW: After expenses.

7 MR. McCABE: -- remain the same.

8 THE COURT: That doesn't make sense to me.

9 MS. WOODROW: What's your net -- what's your net  
10 profit? What did you end up with after everything was  
11 paid? What kind of profit did you have?

12 MR. McCABE: On the sales?

13 MS. WOODROW: Yes.

14 MR. McCABE: It would be about 25 percent of the  
15 sales, total.

16 MS. WOODROW: So about forty thousand? Forty,  
17 fifty thousand?

18 MR. McCABE: Yeah, and when you consider those  
19 years, that's what it -- what it would have been.

20 THE COURT: Well, do you want --

21 MR. McCABE: Most of our expenses was in running  
22 the foundation which has nothing to do with the  
23 publishing aspect of it.

24 THE COURT: Yes, but those expenses are going to  
25 exist in any event, true?

1 MR. McCABE: That's correct.

2 THE COURT: Those are -- whether they are fixed  
3 or variable, they are nevertheless associated -- expenses  
4 that were associated with the independent operation of  
5 the foundation.

6 Now, next question in terms of the way we've  
7 kind of narrowed this, we've got two things kind of going  
8 on. Does the plaintiff take the position that in  
9 measuring the restitution remedy, you're entitled to your  
10 lost revenue on the one hand or to whatever he would have  
11 or did earn? It seems to me those are mutually  
12 exclusive.

13 MS. WOODROW: I don't -- I've ordered the  
14 restatement of contracts and that hasn't come, that  
15 volume. They didn't send it yet so I haven't necessarily  
16 been able to do the research on that.

17 THE COURT: Mr. Morrow, you're a cost  
18 accountant.

19 MR. MORROW: Yes, sir.

20 THE COURT: What do you -- if we were going to  
21 try to account for placing the parties back in the  
22 position that they would have been, had rather -- you've  
23 gone -- simply stopped at the stage in which you proposed  
24 Wave 3 and the other approaches, how do you think you  
25 develop a formula? I mean, we've talked about gross

1 revenue but we really are talking about net revenue and  
2 placing both parties back in the position they would have  
3 been had that event not taken place.

4 MR. MORROW: It's a little more complicated than  
5 that, your Honor. You would also need to account for the  
6 fact that there are various overheads associated with  
7 shipping. For example, the foundation employs two  
8 individuals who do all the shipping. That cost is  
9 directed to the foundation but in reality, it would have  
10 been associated with shipping the goods. You know, if  
11 the foundation elects to change their duties from  
12 shipping goods to whatever, because they are no longer  
13 shipping goods, that cost still would have been there had  
14 they still been shipping.

15 I think probably the easiest way to look at this  
16 is to look at the actual profitability per se of AVKO  
17 itself. While it's a non-profit, it still has to report  
18 a surplus or a deficit. AVKO has been reporting  
19 deficits, as far as I know, for the last several years  
20 while they were shipping all that they were shipping.  
21 So it doesn't seem very likely that there would be a  
22 profit.

23 THE COURT: Prior to -- prior to June of 2010.

24 MR. MORROW: Correct, prior to the transition of  
25 responsibility.

1 THE COURT: Your point, as a cost accountant, is  
2 that each one of those onesie twosie transactions in  
3 terms of net revenue was costing AVKO more than they were  
4 earning.

5 MR. MORROW: Correct.

6 THE COURT: Notwithstanding the fact that Mr.  
7 McCabe, who views those transactions as having  
8 independent significance for the -- for the children that  
9 are learning, as being one of the functions of the  
10 foundation and that sticks in his craw when you say it  
11 isn't worth it. He thinks it's worth it. Your point  
12 simply is that the net revenue doesn't justify it.

13 MR. MORROW: And then there is the additional  
14 strategic issue in that those distributors that are  
15 providing the bulk of his revenue object strenuously to  
16 being sold against by a publisher. So in the end, those  
17 children still get those books but rather than getting  
18 them from me, they get them from christian book  
19 distributors, Rainbow, Timberdoodle, Heppner's Legacy,  
20 children's books, whomever. Not filling the onesie  
21 twosie doesn't prevent that child from getting the book.  
22 It just means they get it from someone other than me.

23 THE COURT: Now, it seems to me that we've got  
24 a much more narrow question in front of us going  
25 forward. We've agreed, if I understand accurately, that

1 you agree that Wave 3 Learning is to be dismissed from  
2 the case.

3 MS. WOODROW: Wave 3 Learning?

4 THE COURT: Yes. You never had a contract with  
5 Wave 3.

6 MS. WOODROW: Correct.

7 THE COURT: You agree that Mr. McCabe has no  
8 particular interest personally in the case. AVKO is the  
9 only party that has a party in interest as a result of  
10 having enforceable legal rights.

11 MS. WOODROW: Yes, your Honor, as to the  
12 contract issues. However, as to the copyright issues, I  
13 think that the author always has an interest in it, even  
14 though he may have assigned those. He, you know --

15 THE COURT: I would strongly suggest that you  
16 look carefully at the law on that question.

17 MS. WOODROW: Okay. He probably doesn't really  
18 have any interest other than emotional.

19 THE COURT: Well, respectfully, the gentleman  
20 has invested a large portion of his life in this product.

21 MS. WOODROW: Yes, but he did assign all the --  
22 he did assign all the copyrights over to the AVKO so  
23 essentially, AVKO is the only interested party.

24 THE COURT: And my point is simply to suggest  
25 that I think it is fair to expect that while he may not

1 have a property interest that would be retained by that  
2 personal property interest, it in part at least at a  
3 certain level reflects his life's work.

4 MS. WOODROW: Yes.

5 THE COURT: And so the fact that he may have a  
6 strong opinion here is not unexpected.

7 MS. WOODROW: Yes.

8 THE COURT: But we are, I think, able to narrow  
9 a couple of additional things down. We've eliminated a  
10 contract cause of action. We've decided that that is an  
11 alternative that you are electing against and that we're  
12 looking at rescission, your choice.

13 MS. WOODROW: Not necessarily. I need to talk  
14 with my clients before I narrow one or the other but I  
15 think we have -- even if we go to rescission, I think we  
16 have to understand that we were placed in this position.  
17 AVKO was placed in this position by the bad faith and the  
18 fraud and misrepresentation and the bad conduct of Mr.  
19 Morrow. Had he not breached his contract, there would  
20 not -- this would not have happened. Had he not  
21 repudiated the contract, there would not have been a need  
22 for any reliance issues. We didn't know he repudiated  
23 the contract and his --

24 THE COURT: You can come back and we can take  
25 testimony from both of these gentlemen, particularly

1 concerning the representations that take place between  
2 June of 2010, at a point in time --

3 MS. WOODROW: You mean after the contract was  
4 signed.

5 THE COURT: Yep, and when HSI and HSH are  
6 folding and Mr. Morrow is leaving. We can take testimony  
7 concerning that. Now, I know, generally, what the two  
8 clients are going to say, at least in part.

9 MS. WOODROW: Correct.

10 THE COURT: I know what Mr. Morrow is going to  
11 say is, I explained the problems that we had with HSH to  
12 the extent of my ability at the time. Indeed, I  
13 explained why the subscription agreement was necessary  
14 for the completion of the refinancing an IPO.

15 Later on, shortly thereafter, when the  
16 transaction began to unwind with HSI and HSH and I left  
17 and I was trying to convince him to go forward with this  
18 transaction, I offered him a promissory note. That was  
19 unacceptable but nevertheless, he did tell me -- he did  
20 tell me, let's just try to maintain the status quo.

21 So it's those set of events as they relate to  
22 an accounting for the two parties' respective financial  
23 circumstances that follow immediately after that, that  
24 are kind of the offsetting claims that we need to  
25 determine with respect to restitution.

1           And having elected that remedy, I would suggest  
2 to you that you are, I believe, entitled to the  
3 restraining order.

4           MS. WOODROW: With the rescission.

5           THE COURT: Provided that the bond is in place  
6 so that in net, you owe them more money than they owe  
7 you. That's the purpose of a bond with a restraining  
8 order.

9           MS. WOODROW: Thank you, your Honor.

10          THE COURT: Now, what I will do is try to locate  
11 some additional -- if I can find like a two-hour block of  
12 time because I have to start -- I have to start switching  
13 gears for the calendar for --

14          MS. WOODROW: The next hearing, yes, your Honor.

15          THE COURT: -- the hearing this afternoon,  
16 hopefully in the next four or five weeks. And then I  
17 will look to you for some guidance as to whether or not  
18 you need that time.

19          Now, here -- here is the question that I've got  
20 because I would anticipate you're going to need a bond at  
21 least in the amount of \$75,000.

22          MS. WOODROW: Okay.

23          THE COURT: It's been a while since I've been in  
24 practice. There were two ways in which I was always able  
25 to do that with my client. If I had \$75,000 worth of



1 cash of AVKO at a bank, I was often able to get a bank to  
2 segregate the seven hundred and fifty thousand dollars  
3 and issue a bond commitment that with those segregated  
4 funds, that they would remain segregated and available  
5 for -- for payment.

6 MS. WOODROW: Are you saying the bond amount  
7 should be seventy-five thousand or seven hundred fifty?

8 THE COURT: Seventy-five.

9 MS. WOODROW: Thousand.

10 THE COURT: For the benefit of Wave 3/Morrow.  
11 Because I know that there was \$25,000 -- excuse me,  
12 \$75,000 that have changed hands.

13 MS. WOODROW: Okay.

14 THE COURT: The alternative is to go to an  
15 insurance company and they will do the same thing which  
16 is to essentially say, we need collateral in the amount  
17 of a hundred -- a hundred to a hundred twenty-five  
18 thousand and we will write you a bond and that will  
19 cost -- the premium that we are going to charge you is  
20 \$5,000 for doing that.

21 MS. WOODROW: All right.

22 THE COURT: But given the fact that we know that  
23 money changed hands and the requirements for the  
24 restraining order, that bond, I think, is appropriate  
25 under the circumstances.

1           There may be some offsetting entries. I  
2 appreciate that. That's what we'll have to work out in  
3 the courtroom as a result of our focus on the  
4 representations that got made when HSI folded and Mr.  
5 Morrow elected to attempt to continue the transaction,  
6 what he explained to Mr. McCabe, and then we will sort  
7 out the expenses that are associated with disassociating  
8 these folks going forward. And that will be the focus of  
9 our -- our next hearing.

10           I believe under those sets of circumstances,  
11 that the issue of whether we are dealing with  
12 distribution rights versus an ownership interest in the  
13 copyrights is irrelevant. That goes away.

14           I appreciate your time this morning.

15           MS. WOODROW: Thank you very much, your Honor.

16           MR. DI GIACOMO: Your Honor, before you  
17 complete, we do still have three outstanding motions.  
18 I'm assuming that the Motion to Strike is done away with  
19 by today's proceeding. We have a Motion for Default  
20 that's still on the table. And we also have a Motion to  
21 Amend the Plaintiff's Complaint.

22           How should we dispose of them? Those were --  
23 those were noticed for today's hearing.

24           MS. WOODROW: Can we continue those?

25           THE COURT: You really don't have opposition to

1 their Motion to Amend.

2 MR. DI GIACOMO: I have opposition in the sense  
3 that they've added a claim and delivery claim that is  
4 simply not justified by the facts, your Honor. Claim and  
5 delivery does not apply to intangible property.

6 THE COURT: Right.

7 MR. DI GIACOMO: Both under the federal rules  
8 and under state law.

9 MS. WOODROW: Well, we want the actual disks  
10 back, some of the materials back. That would be -- if  
11 there is a rescission, then we would -- we would be  
12 entitled to have that back.

13 MR. DI GIACOMO: Presuming that the plaintiff  
14 wants to --

15 MS. WOODROW: That would be a declaratory  
16 judgment count.

17 THE COURT: I think her thinking is to limit the  
18 claim and delivery action to tangible property.

19 MS. WOODROW: Disks are tangible.

20 THE COURT: But that you sold.

21 MS. WOODROW: Not the disks. Not the disks that  
22 they gave them, where they gave them the materials.

23 THE COURT: But they have never been paid for  
24 that.

25 MR. DI GIACOMO: Your Honor, the Copyright Act

1 says that any rights coextensive with Section 106 are  
2 preempted by federal copyright law, including the  
3 embodiment of works on this. That's the reason that we  
4 filed our opposition to the Plaintiff's Motion to Amend  
5 the Complaint.

6 THE COURT: And that's not simply to say that  
7 they lose any entitlement --

8 MR. DI GIACOMO: No, not at all.

9 THE COURT: -- to the extent they are legally  
10 right. It's just the wrong remedy.

11 MR. DI GIACOMO: We just want to make sure that  
12 the extent of this proceeding is limited as much as  
13 possible.

14 MS. WOODROW: So you're objecting to replevin.

15 MR. DI GIACOMO: Yes. And I'm assuming that the  
16 plaintiff would want to amend in light of discussions  
17 with the client relating to the election of rescission  
18 versus contract. I just want to make that clear for the  
19 record.

20 THE COURT: And let me indicate while we have  
21 not issued a written opinion, I recall the events related  
22 to the default -- request for default judgment. If  
23 necessary, I will be denying that request.

24 MR. DI GIACOMO: Thank you, your Honor.

25 MS. WOODROW: Thank you, your Honor.

1           THE COURT: The record is closed. Thank you for  
2 your time this morning.

3           MS. WOODROW: Thank you. I appreciate your  
4 efforts.

5           THE LAW CLERK: All rise. Court is now  
6 adjourned.

7           (At 12:27 p.m. - proceedings adjourned)

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*CERTIFICATE OF COURT REPORTER*

I, PEG L. GOODRICH, Official Court  
Reporter in and for the United States District  
Court, Eastern District of Michigan, appointed  
pursuant to the provisions of Title 28, United  
States Code, Section 753, do hereby certify that  
the foregoing proceedings held before the HONORABLE  
THOMAS L. LUDINGTON, District Court Judge, is a true  
and correct transcript of my stenotype notes in the  
matter of AVKO EDUCATIONAL RESEARCH FOUNDATION,  
et al., v THOMAS A. MORROW, et al., File No.  
11-13381, held on Monday, January 23, 2012.

s/Peg L. Goodrich  
Peg L. Goodrich, CSR, RPR, RMR  
Federal Official Court Reporter  
United States District Court  
Eastern District of Michigan

Date: January 30, 2012  
Bay City, Michigan